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REVENUE RAISING OPTIONS REQUIRED UNDER THE FISCAL YEAR 1988 BUDGET RESOLUTION

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

JULY 15 AND 16

(Part 1 of 2)

Printed for the use of the Committee on Finance

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REVENUE RAISING OPTIONS REQUIRED UNDER THE FISCAL YEAR 1988 BUDGET RESOLUTION

WEDNESDAY, JULY 15, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee was convened, pursuant to notice, at 10 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman) presiding.

Present: Senators Bentsen, Baucus, Rockefeller, Packwood, Roth, Chafee, Heinz, Wallop, and Durenberger.

[The press release announcing the hearing and an opening statement of Senator George Mitchell follow:]

[Press Release No. H-56, July 7, 1987]

FINANCE COMMITTEE TO HOLD HEARINGS ON BUDGET RESOLUTION

WASHINGTON, DC.—Senator Lloyd Bentsen (D., Texas), Chairman of the Senate Finance Committee, announced today that a series of three hearings will be held to consider the committee's obligation for raising revenues as required under the budget resolution for fiscal year 1988.

"The budget resolution passed by the Congress instructs the Finance Committee to report legislation raising $19.3 billion in new revenues for fiscal year 1988. The hearings will enable the committee to examine all possible options for meeting its goal," Bentsen said.

The hearings will focus on all available revenue options, particularly those included in the Joint Tax Committee's staff pamphlet published on June 25, 1987.

The hearings are scheduled for Wednesday, Thursday and Friday, July 15, 16 and 17, 1987 at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

STATEMENT OF SENATOR GEORGE J. MITCHELL
SENATE COMMITTEE ON FINANCE
HEARING ON REVENUE OPTIONS
JULY 15, 1987

This Committee faces a very difficult job as we attempt to fulfill our instructions under the budget resolution to raise more than $19 billion in revenue for the next fiscal year.

That job has been made all the more difficult by the President's position on federal revenues. It is clear that the President prefers a confrontation with Congress to a bipartisan effort to reduce the budget deficit.

The revenue instructions in Congress' budget differ in some respects from the Administration's revenue proposals. The President has used this to score political points against a deficit reduction package in Congress which includes revenue increases. The President says he is against any increase in federal revenues which are not identical to the revenue increases he has proposed.

The President proposed a budget in January that depended on federal revenue increases for more than half of its deficit reduction. Most of the $22 billion in increased revenues he proposed for fiscal year 1988 would have been raised from the sale of government assets. Another large portion of the revenue increase would come from user fees on a variety of federal activities. Approximately $6 billion would come from proposals the Administration defines as "true" tax increases.

As it has in past years, Congress has rejected many of the Administration's user fee proposals as ill advised, regressive levies. Congress also has rejected the Administration's proposed asset sales as phony revenue raisers which bring in temporary, one-time revenue at the expense of future income.

The Congressional budget resolution attempts to address this problem honestly by instructing the Finance Committee to find $19.3 billion in increased revenues, not including user fees or asset sales.

(3)

We all know that revenue increases are not popoular with the American people. It is difficult to appreciate the insidious effects of large federal deficits which sap stength from the national economy. In contrast, tax increases are much more noticeable and it is difficult for the American people to accept them as necessary.

The President, as he has in the past, will take advantage of that situation. He thinks he can earn political capital by claiming steadfast refusal to raise taxes. The President wants to establish a legacy of absolute opposition to tax increases.

Well, that won't work. President Reagan claims to be a great opponent of federal taxes. But in truth he is only opposed to the progressive income tax. Going back to 1982, he has proposed, endorsed, and signed into law a series of tax increases which disproportionately rely on regressive excise and payroll taxes and user fees to raise federal revenues. The trend is continued in the Administration's proposed budget this year.

More importantly, Ronald Reagan cannot leave a legacy as an opponent of federal taxes because his reputation as the greatest deficit spender in history will be writ much larger.

When history is recorded, the 1980's will be known as the period in American history when the federal government embraced dangerous and irresponsible fiscal policies to achieve short term benefits at the expense of the long term interests of the nation.

Over the next three days we will hear from a number of economists who will testify to the dangers of large and continuing budget deficits and the overriding need to take meaningful action to reduce those deficits. They will point out how large federal budget deficits have created a savings shortfall which has increased interest rates while creating a national dependancy on foreign capital.

All of this has destroyed our trade competitiveness, cost millions of jobs, bloated federal interest payments, and transfered current tax burdens to future generations.

Unfortunately, the prospect that this nation will be able to make meaningful reductions in the federal deficit do not appear promising.

That does not have to be the case. I hope we can work together on this Committee in a bipartisan effort to make the difficult decisions that are necessary to reduce the federal deficit.

Because we face such overwhelming political obstacles to meeting our revenue targets, we must be willing to consider a wide range of options. I am willing to keep an open mind. But I cannot support revenue increases which extract disproportionate tax burdens from those low and middle income families least able to afford increased tax burdens. I am particualrly concerned that this Committee not focus on excise taxes as a means of raising revenues to meet the deficit reduction targets in the budget resolution.

Over the last several years, there has been a steady erosion of the progressivity of the federal revenue system. This has resulted from the diminished importance of the federal income tax relative to payroll and excise taxes. Overall federal tax burdens have tended to move down the income scale as income tax rates have declined.

This trend culminated in the Tax Reform Act of 1986 with its excessive reduction in tax rates for the wealthiest individuals.

I am pleased that legislation also included substantial and necessary tax reduction for the lowest income taxpayers. However, as several recent studies have clearly documented, low-income tax reduction in tax reform can quickly be taken back by even modest excise tax increases this year.

Last fall, I requested the Congressional Budget Office to conduct a study of the distributional effects of an increase in selected federal excise taxes. That study, which was released in January, produced much information detailing the extreme regressivity of excise taxes.

For the excise taxes studied, CBO found that the average increase in taxes as a percentage of total income would be about twice as large for families with incomes between $10,000 and $20,000 compared to families with incomes of $50,000 or more. For tobacco and beer excise taxes the burden would be three times as large on families with incomes between $10,000 and $20,000 as on families with incomes over $50,000.

A family earning $15,000 will on average spend over 14 percent of its income on products now subject to federal excise taxes. In contrast, the average family making over $50,000 will spend less than 6 percent of its income on products subject to federal excise taxes.

These numbers indicate that the benefits of tax reform for low and moderate income taxpayers will be quickly lost if excise taxes are increased. CBO calculations indicate that every $1 billion increase in excise taxes from any of the major excise taxes would offset from 9 to 13 percent of the average tax relief provided in tax reform to families with less than $10,000 income. In contrast, the same excise tax increase would offset from .5 to 2 percent of the average tax relief provided to families in the above $100,000 income group.

All of those numbers tell a story which I hope everyone in Congress has now heard. The basic purpose of tax reform to increase the fairness of the tax system will have been repealed if Congress increases excise taxes this year.

In meeting the revenue instructions under the budget resolution, we must not focus on regressive excise taxes.

I look forward to reviewing the testimony over the next three days and hope this Committee will receive constructive recommendations on how to meet our revenue instructions.

The CHAIRMAN. This hearing will come to order, if you will please be seated and cease conversation. I think there is universal agreement that we have two extremely serious things facing this country of ours. One is the budget deficit, and the other is the trade deficit; and they are catastrophes waiting to happen.

I think there is universal agreement that we have to cut this budget deficit and finally eliminate it entirely.

I think there is a majority view that what we should do is work first at cutting back on spending, but that by itself will ultimately not be enough to make the kind of a cut in this deficit that is necessary.

And that means you are going to have to raise some additional revenues for the Government. The President's budget certainly indicates that. The President's budget calls for additional revenues of approximately $22 billion for fiscal year 1988; and of those revenues, $6.1 billion are in a category that the Government calls "Government receipts."

That is just another euphemism. It is another term for taxes. The remainder of that $22 billion is raised through the sale of assets, loan sales, and user fees and various other miscellaneous revenues.

To use the President's terminology, the budget resolution passed by the Congress requires the Finance Committee to come up with $19.3 billion in additional "Government receipts" in fiscal year 1988 and smaller increases from other revenue sources.

Now, that reflects a Congressional determination that Government receipts are a better way of raising revenue than the various proposals made by the President.

We have an agreement between the Congress and the President on the need to reduce the deficit. We have an agreement that some additional revenues will be needed to reduce the deficit. We have a disagreement, though, on how those revenues should be raised.

What we must not do is allow this disagreement—as crucial as it is—to overshadow the urgent need for additional cuts in the Federal deficit this year.

Further reductions in the Federal deficit, I think, are a national imperative. Interest payments by the Government today equal about 40 percent of all revenues raised by the personal income tax, and that percentage is going to continue to escalate unless we turn it around.

So, what we are doing is spending the money of future generations; and that means that we are passing on staggering debts to our children, and we are running up bills that our children are going to have to account for.

That reminds me of a kid I saw the other day who was wearing a T-shirt that said, "How can I be broke? I still have checks." That is not what we expect out of a Congress that faces up to its responsibilities.

This committee, with its broad jurisdiction, has to look at all of the choices that are available for increasing revenues; and that is what these hearings are all about.

We are going to be questioning many witnesses. It is my hope that we can approach this thankless task in a spirit of bipartisanship. We have taken that kind of a bipartisan approach on trade, on catastrophic health coverage, and on other issues that have been before this committee this year.

I want us, to the best of our ability, to develop a broad concensus in what we put together. Right now, we are having a caucus that is taking place on the budget, and that is where most of the members are.

But as these hearings develop, you will see all members of this committee make an appearance.

I know that the President has made it difficult for us to try to raise taxes, on either side of the aisle. I hope that he will participate in the process. It is my hope that the President and the Congress will sit down together and work out a budget compromise that makes sense for the country.

But until that compromise is arrived at, we have some work to do. There is not a lot of time left before the start of fiscal year 1988, and we have to develop a program for making further reductions in the Federal deficit, both by cuts in appropriations and by raising additional revenues.

It is the obligation of this committee to put together the best, the fairest revenue-raising package that we can accomplish.

The task will not be easy, but that is our responsibility and our job.

I now defer to the distinguished Senator Chafee, my friend, for any comment he might want to make.

Senator CHAFEE. Thank you very much, Mr. Chairman.

I do not have any statement. I look forward to hearing the witnesses. Thank you.

The CHAIRMAN. We are honored and pleased to have the distinguished Senator from North Carolina, Senator Helms. Would you come forward, sir? We have Senator Mitch McConnell from the State of Kentucky, if you would come forward. We will let each of you gentlemen speak in turn. We have Senator Terry Sanford, who is a United States Senator from North Carolina. We are proud to have you with us, sir. We have an old friend of mine, Congressman Mervyn Dymally from the State of California. If you would come forward, sir?

We have the Honorable Judd Gregg, United States Congressman from the State of New Hampshire, and the Honorable James Jeffords, U.S. Congressman from the State of Vermont.

Gentlemen, we are impressed with your interest and are delighted to have you. Senator Helms?

STATEMENT OF HON. JESSE HELMS, U.S. SENATOR FROM THE STATE OF NORTH CAROLINA

Senator HELMS. Mr. Chairman and distinguished members of this fine committee, thank you for the opportunity to be here; and I suspect that most of the arguments that we will be making with respect to the proposed increases in excise tax you have heard before. This will just be the second verse, same as the first.

That is the way we do things around here, and I can guarantee you one thing: I am going to summarize my statement because I have presided over many a committee meeting where the witnesses read every syllable; but I shall summarize and be as brief as possible.

I ask unanimous consent, Mr. Chairman, that a statement by the able Senator from Kentucky, Mr. Ford, be included as part of this record.

Senator **Bentsen**. Without objection, that is so ordered.

Senator **Helms**. Obviously, Mr. Chairman, I am here today to appear on behalf of more than 200,000 tobacco growers and their families in North Carolina alone to oppose an increase in the Federal excise tax on tobacco products.

A recent report by the Joint Committee on Taxation states that the most recent increase in the tobacco excise tax occurred in 1982 when it was temporarily increased from 8 to 16 cents per pack. In truth, the most recent increase occurred on April 7, 1986 because that is when the President reluctantly signed the fiscal year 1987 Reconciliation Bill and made permanent the 16 cents per pack tax.

Now, Mr. Chairman and members of the committee, there are so many reasons why a regressive sales tax on tobacco products is the worst way possible for the Federal Government to attempt to increase its revenues.

For one thing, when the Federal Government increases the level of excise tax, many States anticipating a decline in sales immediately enact similar increases in order to maintain their existing levels of revenue from those taxes.

Now, this year approximately 35 States have or will consider legislation increasing the excise tax on tobacco products. A list of States and respective proposals I would submit for the record. Also attached to my statement, and I will submit it for the record, is a list of current levels of State cigarette taxes.

So, if the Congress increases the tax on tobacco products, it must do so with the knowledge that the tax burden for consumers will—more likely than not—be similarly increased at the State and local levels.

Mr. Chairman, in January of this year, the Congressional Budget Office, at the request of Senator George Mitchell of Maine, examined the distributional effects of an increase in selected Federal excise taxes, and the study analyzed increases in the excise tax on seven commodities: beer, wine, liquor, tobacco, gasoline, airfare, and telephone service.

Lest there be any doubt as to the regressive impact of excise taxes in general, let me quote the conclusion reached by CBO: "An increase in the excise tax on tobacco would be the most regressive of all the tax increased considered."

I might add that Jim Miller of OMB is a nonsmoker.

Some will argue that because the use of tobacco is discretionary, that somehow lessens the regressive impact of the tax. But I think we have to ask ourselves: Is a sales tax on food items such as cookies and candies any less regressive because it could be classified as a "discretionary item" or items? I don't think the consumer would think it is less regressive.

A tax is a tax, regardless of how it is imposed, on what product it is placed, or what it is called.

Now, an increase in the excise tax could and would negate the economic benefit of these actions. The tobacco industry currently contributes $2.7 billion to the positive side of the U.S. trade balance. It does not even make good nonsense, in my judgment, to penalize a segment of our economy, which is making such a significant effort to help improve our trade deficit.

Now, as I said at the outset, I am really here on behalf of the 200,000 farmers in my State who make their living or a substantial portion of it with this crop. It is a cash crop in the truest sense of the word.

It is good business practice for the farmer in some geographic regions to grow tobacco. In many instances, the production of tobacco enables the farmer to finance other operations on his farm or other commodities.

An increase in the excise tax will hit these 200,000 farmers where it hurts. Congress is—as the chairman indicated in his opening statement—faced with a difficult problem in trying to move toward a balanced budget.

I happen to believe that the best way to do it is by reducing Federal spending, not taking more money from the American taxpayer. 57.4 percent of all of the cigarettes manufactured in the United States are manufactured in North Carolina.

In attempting to make up for Congress' failure to reduce the growth of Federal spending, Mr. Chairman, I think it is patently unfair to place the burden on one or a few States. In fact, it is unfair to place the burden on the American taxpayer at all. I thank the chairman.

The CHAIRMAN. Thank you very much, Senator. And thank you very much for observing the time limitation. It is a helpful statement, and I know how deeply you feel on the issue.

Senator McConnell?

[The prepared statements of Senators Helms and Ford follow:]

STATEMENT OF THE HONORABLE JESSE HELMS BEFORE THE SENATE COMMITTEE ON FINANCE

JULY 15, 1987

Mr. Chairman. I appear before you today on behalf of more than 200,000 tobacco growers and their families in my state to oppose an increase in the federal excise tax on tobacco products.

A recent report by the Joint Committee on Taxation states that the most recent increase in the tobacco excise tax occurred in 1982 when it was temporarily increased from 8 to 16 cents per pack. In truth, the most recent increase occurred on April 7, 1986. That's when the President signed the FY87 reconciliation bill and made permanent the 16 cents per pack tax.

Mr. Chairman, there are numerous reasons why a regressive sales tax on tobacco products is the worst way for the federal government to attempt to raise revenue. For one thing, when the federal government increases the level of excise tax on tobacco, many states, anticipating a decline in sales, immediately enact similar increases in order to maintain their existing levels of revenue from these taxes.

This year, approximately 35 states have or will consider legislation increasing the excise tax on tobacco products. A list of states and respective proposals is attached. Also attached is a list of current levels of state cigarette taxes. If the Congress increases the tax on tobacco products, it must do so with the knowledge that the tax burden for consumers will, more likely than not, be similarly increased at the state and local level as well.

Mr. Chairman, let me give you the most recent estimates of the impact that a 16 cent increase in the tobacco excise tax would have on this country's tobacco industry. It would result in a decline in 1988 cigarette domestic sales of 1.76 billion packs. The total industry decline in salaries and wages in all four core sectors would be about $928 million. State and local excise and sales tax revenues losses would be approximately $388 million. Finally, employment opportunities would be cut by 35,000 equivalent jobs.

Mr. Chairman, in January of this year, the Congressional Budget Office (CBO), at the request of Senator George

Mitchell, examined the distributional effects of an increase in selected federal excise taxes. The study analyzed increases in the excise tax on seven commodities: beer, wine, liquor, tobacco, gasoline, airfare, and telephone service. Lest there be any doubt as to the regress impact of excise taxes in general, and on tobacco specifically, let me quote the conclusion reached by CBO:

> An increase in the excise tax on tobacco would be the most regressive of all the tax increases considered.

Some will argue that because the use of tobacco is discretionary, that somehow lessens the regressive impact of the tax. I ask, is a sales tax on food items such as cookies or candy any less regressive because it could be classified as a "discretionary item"? I don't think the consumer would think it is less regressive. A tax is a tax, regardless of how it is imposed, on what product it is placed, or what it is called.

In attempting to make the distinction between what is necessary and what is discretionary, we cross the fine line between the right of consumers to choose in a free market and government regulation of individual behavior. An individual who has made a choice on whether to purchase a product should not be penalized with an additional tax burden because of his choice.

Another argument is that an increase in the excise tax could be used to offset costs of administering programs of the Bureau of Alcohol, Tobacco, and Firearms. The current revenue from the tobacco excise tax, approximately $5 billion, goes to the general revenue fund of the treasury and is then disbursed through the normal appropriation process of Congress. This committee has been hesitant, and rightfully so, to earmark portions of existing excise taxes. Given the mandate under the budget resolution of increasing revenue to reduce the federal deficit, I would suggest that implementing a new earmarking of this tax would make that task even more difficult.

In the most recent reconciliation law, the time allowed for electronic transfer of excise taxes for tobacco products was decreased, thus allowing the government to realize additional funds from longer interest periods. This change, in addition to the tobacco manufacturers' exemplary tax compliance record, offsets any arguments in support of an increase to pay for the administration costs of the bureau.

I now turn to several points not readily apparent to committee members, but ones which should be considered. The Third District of North Carolina produces more tobacco than any other congressional district in the country. Without having each of you visit that district for an extended period of time, it is difficult to convey the economic importance of tobacco to that area and to the entire state. For some, tobacco is a controversial and sometimes emotional issue. Regardless, it remains an issue which affects hundreds of thousands of lives and livelihoods of honest, hardworking Americans.

Tobacco growers and manufacturers have learned to work together to address current and potential problems in order to maintain this viable segment of American agriculture. The result of this work is a strong, yet somewhat delicate, program which would be unfairly disrupted by an increase in the federal excise tax on tobacco.

This committee is concerned with reducing the trade deficit as well as the budget deficit. Within the past two years, growers and manufacturers have addressed their own trade problems. The tobacco farmers have agreed to several major changes in the tobacco program including a significant decrease in price, making their product more competitive in both domestic and international markets. Manufacturers have agreed to purchase surplus American tobacco stocks, and individual manufacturers have agreed to decrease purchases of imported tobacco for use in domestic products.

An increase in the excise tax could negate the economic benefit of these actions. The tobacco industry currently contributes $2.7 billion to the positive side of the U.S. trade. It doesn't even make good nonsense to penalize a segment of our economy which is making a significant effort to help improve our trade deficit.

I can state without hesitation or doubt that next to the consumer, the American tobacco farmer will suffer most from an increase in the tobacco excise tax. Tobacco is a cash crop in the truest sense of the word. It is good business practice for a farmer in some geographic regions to grow tobacco. In many instances, the production of tobacco enables the farmer to finance other operations on his farm. An increase in the excise tax will result in less tobacco being produced and sold by the American farmer. There are no acceptable alternatives for most tobacco farmers to make up for the loss in income. This, of course will have a ripple, if not a wave, effect in communities throughout the southeastern United States which depend on this commodity as their economic backbone.

Congress is faced with tremendous problems in attempting to keep American agriculture viable. Tobacco production is a proud profession and one which has shown the ability to deal with its own problems. The dilemma facing the American farmer will be accelerated if this committee increases the excise tax on tobacco products.

You may be interested to know that 57.4% of all cigarettes manufactured in the United States are manufactured in North Carolina. In attempting to make up for Congress' failure to reduce the growth of federal spending, it is patently unfair to place the burden on one or a few states. In fact it's unfair to place the burden on the American taxpayer at all.

STATE CIGARETTE EXCISE TAX RATES

(cents per 20-pack)

North Carolina	2
Virginia	2.5
Kentucky	3
South Carolina	7
Wyoming	8
California	10
Indiana	10.5
Georgia	12
Maryland	13
Missouri	13
Tennessee	13
Delaware	14
Ohio	14
Nevada	15
New Mexico	15
Arizona	15
Alaska	16
Louisiana	16
Montana	16
Alabama	16.5
New Hampshire	17
Vermont	17
Dist. of Columiba	17
West Virginia	17
Idaho	18
Mississippi	18
Oklahoma	18
Pennsylvania	18
Colorado	20
Illinois	20
Texas	20.5
Arkansas	21
Michigan	21
New York	21
Utah	23 [a]
South Dakota	23
Minnesota	23
Florida	24
Kansas	24
Rhode Island	25
New Jersey	25 [b]
Wisconsin	25
Massachusetts	26
Iowa	26
Connecticut	26
Nebraska	27 [c]
North Dakota	27 [d]
Oregon	27
Maine	28
Hawaii	29 [e]
Washington	31

[a] Rate includes 11 cent increase effective 4/27/87

[b] Includes surtax escalator; 19 cent excise + 6 percent surtax

[c] Rate includes 4 cent increase effective 7/1/87

[d] Rate includes 9 cent increase effective 7/1/87

[e] Rate is 40% of wholsale price

STATE LEGISLATION IN 1987 TO INCREASE EXCISE TAX ON TOBACCO PRODUCTS

State	Proposed change	Status
Alabama	+10¢	Pending
California	+25	Pending
Connecticut	+ 1 percent ad valorem	Rejected
Florida	+ 1	Rejected
Hawaii	+12	Rejected (Tax is ad valorem, increases w/price)
Idaho	+8.9	Raised 8.9¢ eff. 4/1/87
Indiana	+ 5	Raised 5¢ eff. 7/1/87
Iowa	+10	Rejected
Massachusetts	+ 8	Pending
Michigan	+ 5	Rejected
Minnesota	+18	Raised 15¢ eff. 6/1/87
Mississippi	+ 1	Rejected
Missouri	+ 8	Rejected
Montana	+10	Rejected
Nebraska	+ 4	Raised 4¢ eff. 7/1/87
Nevada	+ 5	Raised 5¢ eff. 7/1/87-6/30/89
New Hampshire	+ 1	Rejected
New Jersey	+ 5	Pending
New York	+ 3	Pending
North Dakota	+ 9	Raised 9¢ eff. 7/1/87
Ohio	+ 5	Raised 5¢ eff. 7/15/87
Oklahoma	+ 5	Raised 5¢ eff. 6/1/87
Oregon	+10	Rejected
Pennsylvania	+ 2	Pending
South Carolina	+10	Rejected
South Dakota	+ 5	Rejected
Texas	+9.5	Pending
Utah	+11	Raised 11¢ eff. 4/27/87
Washington	replace with ad valorem	Rejected
West Virginia	replace with 28% ad valorem	Rejected
Wisconsin	+ 5	Pending

PREPARED STATEMENT OF SENATOR WENDELL H. FORD
A U.S. SENATOR OF THE STATE OF KENTUCKY

Mr. Chairman, members of the Committee, I appreciate being given the opportunity to testify before you about a subject of great concern to my constitutents: cigarette excise taxes.

I want to be up-front with the committee. I voted for the Senate budget resolution which required $18 billion in new revenues in the next fiscal year. And I voted for the budget conference report which requires more than $19 billion in new revenues. So I am one of those responsible for giving this committee the headache of coming up with these new dollars. But I supported this budget because I believe that we cannot continue to mortgage the future of our children by letting the federal deficit grow. And I believe that Congress can come up with these revenues in a way that is fair to all Americans. And in a way that does not fall unevenly on certain groups or industries.

If we are going to be fair, then we cannot rely on regressive excise taxes to fund deficit reduction. Fairness is not defined by what product or industry is taxed, nor by how often the tax has been raised. Fairness is defined by what people pay the tax. After all, manufacturers only collect the tax; it is the American people who pay it.

I doubt there is a single member of this committee, or perhaps even a member of the entire Congress, who does not believe that excise taxes are the most regressive of all taxes. They hit the little people, the poorest people, the hardest. For those who are slow to convert, the Congressional Budget Office study released this spring of the regressive impact of several excise taxes should close the book on the question of out of whose pockets these taxes come.

If I may digress for a moment, I want to commend a member of this committee, my colleague from Maine, Senator Mitchell, for requesting this study. I have to admit I was pleased by the findings. I have been saying for years that the reason we shouldn't fall back on excise taxes, particularly tobacco and distilled spirits, is because they unfairly hit the poor. It's nice to have an authority to back me up.

The CBO study is not the only analysis of the distributional effects of increases in excise taxes. Citizens for Tax Justice (CTJ) also studied the impact of increases in regressive excise taxes on the tax cut produced by the Tax Reform Act of 1986. This study was based upon a hypothetical deficit reduction package which increased the gasoline tax by 12 cents, added 49 cents to the tax on a six-pack of beer and 52 cents on a bottle of wine, with a doubling of the cigarette tax and an extension of the telephone tax at 3 percent for a total of $19 billion in FY 88. The CTJ study concluded that this deficit reduction package would cost families earning less than $10,000 a year more than 2 1/2 percent of their incomes, or more than double the tax cut received under the Tax Reform Act of 1986. Middle-income families would pay about one percent more of their earnings in increased excise taxes, which also would eat up the savings they received from tax reform. On the other hand, families making more than $200,000 a year would only pay 0.1 percent of their incomes in higher excise taxes.

The Coalition Against Regressive Taxation (CART) also commissioned a study of the regressivity of excise taxes. This study, produced by Peat Marwick Main & Co. in May of this year, concluded that families with incomes of less than $10,000 would experience a tax increase 5 times as great as the saving they received from tax reform if $18 billion in deficit reduction was achieved through increased excise taxes. Moreover, this study shows that an increase in excise taxes would fall more heavily on the aged population than the non-aged.

And it is tobacco excise taxes that have the most regressive effect of all the excise taxes. That's not Wendell Ford saying that. That was the conclusion of the Congressional Budget Office. The CART study also concluded that 28.8 percent of tobacco taxes are paid by low to moderate income earners, the second highest percentage for any other excise tax. Only beer, at 29.0 percent, was paid by a higher percentage of low to moderate income earners. Americans with incomes below $5,000 a year spend almost 8 percent of their income on tobacco purchases. Is it fair to tell these Americans that they will have to pay more for deficit reduction than those who make more than $50,000 a year and spend just half a percent of their income on tobacco? It is not.

Now we hear arguments that tobacco has greater social costs than other products, and so users should pay more for its use. But if that is the criteria for taxing people, let's start taxing those who use saccharin, which we know causes cancer in animals. Or let's tax automobiles, a product responsible for a leading cause of death of teenagers. Or what about red meat, or sugar, or asbestos, or any other product that has been directly linked to adverse health conditions. Not all tobacco users have adverse health. Not all automobile drivers have accidents. If we are going to tax according to costs to society, then we had better find a way to tax chemicals, and pollutants, and illegal drugs. Because these substances are going have greater costs to society than the 55 million tobacco users could ever produce.

There are those who also argue that tobacco taxes should be increased because they have not been increased in the past couple of years. If Congress chooses which taxes to use to fund deficit reduction based on how often they have been increased, the working poor in this country will never get ahead. This year we increase cigarettes but not beer. Next year it will be beer's turn but not telephone. The next year will be wine but not distilled spirits. And on and on. The particular industries may not get hit, but the working man, particularly the low-income family, will get hit every year. Revenues should not be judged by how often they are increased, but by the inpact of an increase on consumers and taxpayers. As long as regressive excise taxes form the foundation of deficit reduction, we are ensuring that the rich will get richer at the expense of the working poor.

It is not just low-income Americans who bear the burden of regressive tobacco taxes. It is the entire tobacco industry, starting with the farmer who counts on his allotment to provide the cash base for his farm, to the seasonal worker who strips the tobacco by hand, to the worker at the manufacturer plant, and the foil paper plant, and the cardboard box plant. But it doesn't stop there. Increases in the cigarette excise tax will affect the wholesale distributor, and the retailer, such as the 7-11 or the Convenient store, which experiences a decrease in sales for a high turn-around product. An increase in the tobacco excise tax will have a ripple effect on over 700,000 industry jobs which pay almost $19 billion in yearly wages, in an industry that accounts for over $31 billion of this nation's gross national product.

My colleagues on the Finance Committee might be interested to know that tobacco is not just important to the southeast. Tobacco is a part of the economy of every state, providing both direct and indirect employment and generating billions of dollars in wages. A 1983 study by Chase Econometrics, entitled the Economic Impact of the Tobacco Industry on the United States Economy, revealed the extensive impact of the tobacco industry. In Maine, 1.6 percent of all private sector jobs, or one in every 62 jobs in the state, are generated directly and indirectly or supported by tobacco. Wholesaling, retail sales, and cigarette company supplier operations produce 2,247 jobs in the state at a total income of $32.5 million. Thirty percent of these are directly related to tobacco. The remainder result from the multiplier or ripple effect as tobacco workers, their employers and essential suppliers spend their incomes for goods and services of other non-tobacco industries.

Similarly, in Texas, 1.6 percent of all private sector jobs are generated directly or indirectly or supported by tobacco, representing one in every 62 jobs. Through wholesaling, retail sales and supplier operations, tobacco produces 15,415 jobs with a total annual income of $219.4 million. About one-third of these jobs relate directly to the tobacco industry, and the rest result from the multiplier effect. In Missouri, 1.7 percent of all private sector jobs are directly or indirectly generated or supported by tobacco. This represents one in every 59 private sector jobs in the state. Missouri has 132 jobs, at a total income of $1.03 million, in the growing/processing/manufacturing industries. Wholesaling, retailing and suppliers account for another 10,515 jobs supporting a total annual income of $184.2 million. One third of these jobs are directly related to tobacco.

In New Jersey, 2.4 percent of all private sector jobs are directly or indirectly generated or supported by tobacco, representing one in every 42 such jobs. There are 269 manufacturing jobs in the state supporting annual incomes of $6.9 million. An additional 18,096 jobs in wholesaling, retailing and supplier operations account for total annual incomes of $370.4 million, of which somewhat less than 25 percent are directly attributable to tobacco. In Rhode Island, 1.7 percent of all private sector jobs are generated directly, indirectly or supported by tobacco. This represents one in every 59 jobs in that state. Wholesaling, retailing, and tobacco industry suppliers employee 1,875 workers, at a total annual income of $28.4 million. A quarter of these jobs are directly related to the tobacco industry.

In Oregon 2.2 percent of all private sector jobs are tobacco related, representing one in every 45 jobs. Wholesaling, retailing, and tobacco industry suppliers account for 5,025 jobs with a total annual income of $86.4 million. Somewhat less than a quarter of these jobs are directly related to tobacco with the remainder being created do to the multiplier effect. In Pennsylvania, where tobacco is harvested on 11,000 acres, 21.8 million pounds of tobacco was produced in 1986 at a crop value of $17.2 million. Tobacco supports 3,057 jobs in the growing/processing/manufacturing industries supporting total incomes of $53.0 million. Tobacco generates indirectly, directly or supports 1.9 percent of the private sector jobs, or one in every 53 jobs in that state. Wholesaling, retailing, and tobacco supplier industries account for 25,055 jobs in the state at a total annual income of $473.3 million. About one-third of these jobs are directly related to tobacco.

In New York, 3.3 percent of all the private sector jobs are generated directly, indirected or supported by tobacco. This represents one in every 30 private sector jobs in that state. Tobacco related manufacturing, wholesaling, retailing, and supplier industries account for a total of 49,988 jobs at total annual income of $1.5 million. About one in five of these tobacco-related jobs are generated directly by tobacco. In Oklahoma, 1.4 percent of the private sector jobs in the state are generated directly, indirectly or supported by tobacco, which represents one in every 71 of these jobs. Manufacturing, wholesaling, retailing, and tobacco suppliers account for a total of 6,196 jobs at a total annual income of $109 million. Slightly over one-third of these jobs are directly related to tobacco with the rest produced by the multiplier effect.

In Minnesota, 1.8 percent, or one in every 55, of the private sector jobs are directly or indirectly generated or supported by tobacco. Wholesaling, retailing, and tobacco supplier industries account for 9,362 jobs with total annual incomes of $165.2 million. Under one-third of these jobs are directly related to tobacco, the remainder being created by the multiplier effect. In Michigan, 2.2 percent of all private sector jobs are generated directly or indirectly or supported by tobacco, representing one in every 45 jobs of that kind. Wholesaling, retailing, and tobacco supplier industries account for 15,558 jobs with a total annual income of $277.9 million. Less than one-quarter of these jobs relate directly to tobacco with the rest created due to the multiplier effect.

In Montana, 1.6 jobs are directly or indirectly generated or supported by tobacco, accounting for one in every 62 jobs of that kind in the state. Wholesaling, retailing, and tobacco supplier industries account for 1,613 jobs in the state at a total annual income of $25.2 million. Almost one-third of these jobs relate directly to tobacco. In Hawaii, almost one percent of all private sector jobs, or the equivalent of one in every 111 in the state, are generated directly or indirectly or supported by tobacco. Wholesaling, retailing, and supplier industries account for 2,136 jobs, at a total annual income of $29.3 million. Almost half of these jobs are directly related to tobacco.

In Delaware, 2.0 percent of all private sector jobs, or one in every 50, are supported or generated indirectly or directly by tobacco. Wholesaling, retailing, and supplier industries account for 1,263 jobs at a total annual income of $19.4 million. Almost a fifth of these jobs are directly related to tobacco. In Colorado, 1.5 percent of private sector jobs are generated directly or indirectly by tobacco or supported by it, representing one in every 67 of these jobs. Wholesaling, retailing, and supplier industries account for 6,927 jobs at total annual income of $120 million. Almost one-third of these jobs related directly to tobacco.

In West Virginia, where tobacco is grown, 1,600 acres were harvested in 1986, producing 2.85 million pounds of tobacco with a crop value of $4.5 million. An estimated 1.8 percent of all private sector jobs, or one in every 55, are supported or generated indirectly or directly by tobacco. Manufacturing, wholesaling, retailing, and supplier industries account for 3,624 jobs at a total annual income of $60.1 million. Less than one-third of these jobs are directly related to tobacco. In

Arkansas, 1.7 percent of private sector jobs are generated directly or indirectly by tobacco or supported by it, representing one in every 58 of these jobs. Wholesaling, retailing, and supplier industries account for 3,725 jobs at total annual income of $56.2 million. About one-third of these jobs related directly to tobacco.

In Wyoming, an estimated 1.3 percent of all private sector jobs, or one in every 77, are supported or generated indirectly or directly by tobacco. Wholesaling, retailing, and supplier industries account for 1,003 jobs at a total annual income of $17.7 million. About one-third of these jobs are directly related to tobacco. In South Dakota, 1.1 percent of private sector jobs are generated directly or indirectly by tobacco or supported by it, representing one in every 90 of these jobs. Wholesaling, retailing, and supplier industries account for 1,323 jobs at total annual income of $17.7 million. Almost one-quarter of these jobs related directly to tobacco.

While tobacco has varying impacts on these states it is vital to the economy of Kentucky. The Chase study found that 4.8 percent of all private sector jobs are directly generated by the tobacco industry, or one in every 21 jobs. More importantly, tobacco supports an additional 5.9 percent of employment indirectly. In 1986, Kentucky farmers harvested 159,100 acres of tobacco, with the Burley grown on 145,000 acres. Over 331 million pounds of tobacco was produced in 1986, of which 304.5 million was Burley, with a total crop value of $514.5 million. In Kentucky, tobacco growing, processing and manufacture supports 47,489 jobs, at an total income to Kentucky workers of $580.7 million. Additionally, wholesaling, retailing and supplier industries add 11,865 jobs supporting a total annual income of $259.2 million. Perhaps my colleagues can better understand from these figures why tobacco is so important to the economy of Kentucky.

We don't have to guess what the effect of an increase in the tobacco tax will be; we know. Following the doubling of the tax in 1982 from 8 cents to 16 cents, tobacco farmers lost almost 30 million pounds of tobacco sales. Over 14,000 jobs in tobacco manufacture and distribution were lost and the GNP was reduced by $800 million. If Congress were to double the tax again, to 32 cents per pack of cigarettes, over 28,000 American jobs will be lost and tobacco farmers will lose $110 million in sales on the 37 million pounds of tobacco that won't be purchased. The industry can't afford that kind of a loss; nor can our national economy.

Let me just give you an idea of the effect an increase in the tobacco tax will have on my constituents in Kentucky. A 16 cent increase in the cigarette tax would cost Kentucky 1,509 growing and auction jobs, at a loss of over $10 million in income and benefits. This impact on small farmers and other rural residents is hard to justify at a time when many rural communities in my state are struggling to bounce back from a farm recession. An additional 399 manufacturing jobs would be lost resulting in almost $20 million in lost income and benefits. An estimated 134 wholesale and retail trade jobs would be lost at a cost of $2.3 million in lost income and benefits. And an additional 343 industry support jobs would be lost, representing $10.5 million in lost income and benefits. All of this at a time when the unemployment rate in Kentucky stands at 9 percent while the national average is down to 6 percent. We simply cannot afford to lose any more jobs in Kentucky. Of equal importance, if the cigarette excise tax was doubled, the Commonwealth would lose significant revenues of $4.7 million. I hope my colleagues can now better understand why this issue is of great importance to me and my constituents.

This Congress must reduce the federal deficit. We must come up with new revenues to pay for essential government services while at the same time reducing the deficit. And the criteria for finding those new revenues should be fairness -- fairness to the American taxpayer who gives up the fruits of his individual labor in order to fund government services for us all. Congress should not fall back on regressive excise taxes, especially not cigarette taxes which are the most regressive of all, to fund this deficit. It is not fair to the poor; it is not fair to the farmers; it is not fair to my constitutents who depend upon tobacco to provide their livelihood. It is not fair to those who chose to use a legal product. If deficit reduction is to be meaningful, and lasting, it must come not at the expense of one industry, or one income group, but from realistic spending cuts and new revenues based not on penalties, but on fairness.

The farmers are not blind in my state. They see the handwriting on the wall and realize that more and more Americans are chosing to smoke less, or not at all. And I believe that those are informed choices, coming not from increases in excise taxes, but from better education. Perhaps smoking is losing fashion, but in hastening the end of tobacco use, I urge my colleague not to wipe out our farmers, too. An increase in the cigarette tax does not just bring down smokers. It ultimately will bring down an entire industry and a way of life for the family farmer in Kentucky.

I urge this committee to reject increases in regressive excise taxes, particularly the most regressive tax, the cigarette excise tax, and instead, fund deficit reduction with measures that fall evenly on all Americans.

STATEMENT OF HON. MITCH McCONNELL, U.S. SENATOR FROM THE STATE OF KENTUCKY

Senator McCONNELL. Thank you, Mr. Chairman. I appreciate the chance to be here. Less than a year has gone by since enactment of the Tax Reform Act of 1986, which made the most sweeping changes to the Tax Code in over three decades.

Most people agree that its greatest achievement was to remove six million poor Americans from the tax rolls.

The CHAIRMAN. Let me interrupt for just a minute because I know of the time constraints of each of you. When you finish your testimony, you can go. Otherwise, you can stay, and we would be delighted to have you answer any questions.

Senator McCONNELL. Thank you, Mr. Chairman.

Most people agree that its greatest achievement was to remove six million poor Americans from the tax rolls. It is ironic, then, that we are here today debating not just whether to implement excise taxes, but just what kind of excise tax would be most appropriate.

Excise taxes are the most regressive form of taxation, as my colleague from North Carolina has previously pointed out. Enactment of excise taxes to solve the Federal deficit problem would make a mockery of all we accomplished last year in the name of those less fortunate than ourselves.

A package of excise taxes would completely eliminate the benefits realized by the poor in the Tax Reform Act. In fact, a recent study notes that an $18 billion increase in excise taxes would be nearly five times as great as last year's income tax reduction for families earning less than $10,000. By comparison, the burden on families earning over $200,000 is just one-fiftieth of the income tax reduction.

Furthermore, history shows that when the Federal Government increases the level of excise taxes, many States anticipate a decline in sales and immediately enact similar increases in order to maintain existing levels of revenue from these taxes. According to the Tobacco Institute, this year approximately 25 States have or will consider legislation increasing excise taxes.

But today we are talking about deficit reduction, and I firmly believe that more taxes in this area will not bring more revenue, but in fact less revenue. Even worse, more taxes will result in more farm failures, more unemployment, and a greater tax burden on our nation's poor and elderly.

I include for the record several studies on the regressive nature of excise taxes from the Congressional Budget Office, the Coalition Against Regressive Taxation, and the CO$T Coalition. And Mr. Chairman, I also submit for the record a letter I was pleased to cosign with 23 of my Senate colleagues to the Majority and Minority Leaders on this particular issue.

As Congress begins to address the deficit problem, we should not lose sight of our accomplishment last year in constructing a Tax Code based on fairness and an ability to pay. It is too soon for us to betray this objective by relying too heavily on regressive excise taxes.

Mr. Chairman, as I stated last year, I came to the United States Senate as a big supporter of tax reform. What I cannot explain to my constituents is paying for a budget with an unprecedented increase in the most regressive tax of all.

Thank you very much for the chance to be here.

The **Chairman**. Thank you. We are glad to have you, Senator Sanford, my good friend and able colleague.

[The prepared statement and other material supplied by Senator McConnell follow:]

STATEMENT OF SENATOR MITCH McCONNELL
TO THE SENATE COMMITTEE ON FINANCE
REGARDING PROPOSED INCREASES IN EXCISE TAXES

JULY 15, 1987

GOOD MORNING, MR. CHAIRMAN. I WOULD FIRST LIKE TO THANK YOU FOR INVITING ME TO TESTIFY BEFORE THE FINANCE COMMITTEE ON THIS ISSUE OF EXTREME IMPORTANCE TO MY STATE AND TO MILLIONS OF CONSUMERS THROUGHOUT THE COUNTRY.

AS THE COMMITTEE BEGINS TO DRAFT ITS PROPOSALS FOR RECONCILIATION, I WOULD LIKE TO OFFER MY VIEWS ON WHY I BELIEVE IT IS UNWISE TO ATTEMPT TO MEET THE REVENUE FIGURES ADOPTED IN THE FISCAL YEAR 1988 FEDERAL BUDGET THROUGH THE IMPOSITION OF EXCISE TAXES.

LESS THAN A YEAR HAS GONE BY SINCE ENACTMENT OF THE TAX REFORM ACT OF 1986, WHICH MADE THE MOST SWEEPING CHANGES TO THE TAX CODE IN OVER THREE DECADES. MOST PEOPLE AGREE THAT ITS GREATEST ACHIEVEMENT WAS TO REMOVE 6 MILLION POOR AMERICANS FROM THE TAX ROLLS. ITS IRONIC, THEN, THAT WE ARE HERE TODAY DEBATING NOT JUST WHETHER TO IMPLEMENT EXCISE TAXES, BUT JUST WHAT KIND OF EXCISE TAX WOULD BE MOST APPROPRIATE.

EXCISE TAXES ARE THE MOST REGRESSIVE FORM OF TAXATION. ENACTMENT OF EXCISE TAXES TO SOLVE THE FEDERAL DEFICIT PROBLEM WOULD MAKE A

MOCKERY OF ALL WE ACCOMPLISHED LAST YEAR IN THE NAME OF THOSE LESS FORTUNATE THAN OURSELVES. A PACKAGE OF EXCISE TAXES WOULD COMPLETELY ELIMINATE THE BENEFITS REALIZED BY THE POOR IN THE TAX REFORM ACT. IN FACT, A RECENT STUDY NOTES THAT AN $18 BILLION INCREASE IN EXCISE TAXES WOULD BE NEARLY **FIVE TIMES** AS GREAT AS LAST YEAR'S INCOME TAX REDUCTION FOR FAMILIES EARNING LESS THAN $10,000. BY COMPARISON, THE BURDEN ON FAMILIES EARNING OVER $200,000 OF THE IS JUST **ONE-FIFTIETH** OF THE INCOME TAX REDUCTION.

FURTHERMORE, HISTORY SHOWS THAT WHEN THE FEDERAL GOVERNMENT INCREASES THE LEVEL OF EXCISE TAXES, MANY STATES ANTICIPATE A DECLINE IN SALES AND IMMEDIATELY ENACT SIMILAR INCREASES IN ORDER TO MAINTAIN EXISTING LEVELS OF REVENUE FROM THESE TAXES. ACCORDING TO THE TOBACCO INSTITUTE, THIS YEAR APPROXIMATELY 35 STATES HAVE OR WILL CONSIDER LEGISLATION INCREASING EXCISE TAXES.

BUT TODAY, WE'RE TALKING ABOUT DEFICIT REDUCTION. AND I FIRMLY BELIEVE THAT MORE TAXES IN THIS AREA WILL NOT BRING MORE REVENUE, BUT LESS REVENUE. EVEN WORSE, MORE TAXES WILL RESULT IN MORE FARM FAILURES, MORE UNEMPLOYMENT, AND A GREATER TAX BURDEN ON OUR NATION'S POOR AND ELDERLY.

I INCLUDE FOR THE RECORD SEVERAL STUDIES ON THE REGRESSIVE NATURE OF EXCISE TAXES FROM THE CONGRESSIONAL BUDGET OFFICE, THE COALITION AGAINST REGRESSIVE TAXATION, AND THE CO$T COALITION. I ALSO SUBMITT

FOR THE RECORD TWO LETTERS I WAS PLEASED TO CO-SIGN WITH ~~15~~ 23 OF MY SENATE COLLEAGUES TO THE MAJORITY AND THE MINORITY LEADERS ON THIS ISSUE.

AS CONGRESS BEGINS TO ADDRESS THE DEFICIT PROBLEM, WE SHOULD NOT LOSE SIGHT OF OUR ACCOMPLISHMENT LAST YEAR IN CONSTRUCTING A TAX CODE BASED ON FAIRNESS AND AN ABILITY TO PAY. IT'S TOO SOON FOR US TO BETRAY THIS OBJECTIVE BY RELYING TOO HEAVILY ON REGRESSIVE EXCISE TAXES.

MR. CHAIRMAN, AS I STATED LAST YEAR, I CAME TO THE UNITED STATES SENATE AS A BIG SUPPORTER OF TAX REFORM. WHAT I CANNOT EXPLAIN TO MY CONSTITUENTS IS PAYING FOR A BUDGET WITH AN UNPRECEDENTED INCREASE IN THE MOST REGRESSSIVE TAX OF ALL.

THANK YOU AGAIN FOR THIS OPPORTUNITY TO EXPRESS MY CONCERNS ABOUT EXCISE TAXES.

THE DISTRIBUTIONAL EFFECTS OF AN INCREASE IN SELECTED FEDERAL EXCISE TAXES

Staff Working Paper

January 1987

The Congress of the United States

Congressional Budget Office

This study was prepared at the request of Senator George J. Mitchell of the Committee on Finance, United States Senate. It was written by Frank J. Sammartino of the Tax Analysis Division under the supervision of Rosemary D. Marcuss and Eric J. Toder. Questions regarding this analysis may be addressed to Frank J. Sammartino (226-2688).

SUMMARY

Federal excise taxes accounted for $36 billion in 1985, or 5 percent of all federal revenues. Concern about the rising deficit has prompted some to consider increasing federal excise taxes. This analysis by the Congressional Budget Office shows the distributional effects, among income classes, of a simulated increase of $1 billion in gross excise tax revenues from separate increases in the excise tax on seven commodities: beer, wine, liquor, tobacco, gasoline, airfare, and telephone service.

The distributional effects of the tax increase are measured relative to family income and to total family expenditures. Because total expenditures generally are thought to reflect long-term incomes, total expenditures may be a better measure of a family's permanent economic situation than income in a single year.

When measuring the distributional effects relative to total expenditures, an increase in the airline ticket tax would be slightly progressive across income classes; the average increase in taxes as a percentage of total expenditures would be higher for families in higher income classes. Increases in the tax on wine or, for all but the highest and lowest income classes, the tax on gasoline would have the same effect on all income classes when measured as a percent of total expenditures. Increases in all other excise taxes would be at least marginally regressive; the average increase in taxes as a percentage of total expenditures would be less for families in higher income classes. An increase in the excise tax on tobacco would be the most regressive of all the tax increases considered.

When measuring the distributional effects relative to family income, an increase in any of the taxes except the airline ticket tax would be noticeably regressive. The average increase in taxes as a percentage of total income would be about twice as large (more than three times as large in the case of the tax on beer or tobacco) for families with incomes between $10,000 and $20,000 compared to families with incomes of $50,000 or more.

Because not all families with similar incomes spend the same amount on each of the taxed items, the incidence of an increase in excise taxes would vary greatly within income classes. For expenditures other than on airfare, both the proportion of families with expenditures and the percent of expenditures within 50 percent of the average generally are smallest for families with incomes of less than $10,000. Thus, the incidence of tax increases would vary the most within the lowest income classes.

Increases in the tax on gasoline or telephone services would produce less variation in the incidence of a tax increase among families with similar incomes than would increases in any of the other excise taxes. More than 90 percent of families in all income classes have expenditures on telephone services and, with the exception of families with incomes of less than $10,000, on gasoline. About two-thirds of gasoline and telephone service expenditures are within 50 percent of the average expenditure within each income class (except, again, for gasoline expenditures in the lowest income classes).

A complete analysis of the incidence of an increase in excise taxes includes the effect on relative prices and the effect on personal income. An increase in excise taxes would increase the price of the taxed item relative to the price of other goods and services. Families who spend less than the average amount on the taxed items would be relatively better off, while families who spend more than average would be relatively worse off. An increase in excise taxes would reduce the real value of business receipts, thereby lowering the amount paid out in wages and returns to shareholder investments. With a reduction in these payments, the aggregate real income of workers and investors will fall by the amount of the tax.

When the effects of an excise tax increase on the prices of other goods and services are considered, families in most income classes would neither gain nor lose, on average, from an increase in the tax on wine or distilled spirits. The higher price for those goods would be offset by relatively lower prices for other goods and services. Families in the highest income class would gain on average from an increase in the taxes on gasoline, beer, tobacco, and telephone services. When the effects on relative prices are considered, families in the lowest income classes still would lose on average from an increase in the taxes on tobacco or telephone services, although the amount of loss, whether measured as a percentage of income or as a percentage of total expenditures, would be reduced.

If the reduction in real personal income because of an excise tax increase is distributed proportionally across all wage and investment income, the distributional effects of each excise tax increase would be

more progressive than when only the effects on relative prices are considered. Measured relative to total expenditures, the burden of any of the tax increases (except for tobacco) would be the smallest for families with incomes of $10,000 or less.

Distributing the reduction in personal income proportionally across all wage and investment income does not change the relative ranking among the alternative tax increases according to their distributional effects. If the reduction in income were distributed differently for each separate tax increase--for example, with a larger share going to workers and investors in the industry that produced the good or service that was being taxed--the relative ranking according to distributional effects could change when the full incidence of the tax was included.

INTRODUCTION

In fiscal year 1985, revenues from all federal excise taxes were $36 billion, approximately 5 percent of total federal revenues in that year. Continuing pressures to reduce federal deficits have caused some to consider increasing excise taxes. In this paper, the Congressional Budget Office (CBO) analyzes the distributional effects, by income class, of separate increases in selected excise taxes. For each tax, the simulated increase in the tax rate is designed to generate an additional $1 billion in gross excise tax revenues before inclusion of the associated reduction in income taxes. Increases are simulated for excise taxes on beer, wine, distilled spirits (liquor), tobacco, gasoline, air passenger tickets, and communications (telephone service). These taxes accounted for approximately 65 percent of total federal excise tax liabilities (almost 80 percent of excise tax liabilities excluding the windfall profit tax) in 1985.

The distributional consequences are only one of a number of criteria for comparing the merits of revenue-equivalent increases in different federal excise taxes. Revenues from some excise taxes are earmarked for specific outlays. Revenues from the federal excise tax on gasoline go into the Highway Trust Fund which is used to finance construction and improvements of highways, bridges, and mass transit facilities; revenues from the tax on airline tickets go into the Airport and Airway Trust Fund.

Other excise taxes can be seen as compensation for the social costs that society in general ultimately bears because of certain activities. For example, the tax on tobacco products may offset some of the higher medical costs that smokers incur, while the tax on alcoholic beverages may offset some of the social costs from alcoholism and alcohol-related automobile accidents.

In the first section of this paper, CBO presents data on the distribution of consumer expenditures, by income class, on the seven commodities. The next section then analyzes the distribution of excise tax payments on those expenditures. The third section shows simulated distributional effects of a $1 billion increase in gross revenues from each tax considered in turn. In the final section, CBO analyzes the full incidence of these excise tax increases, including their effects on relative prices, consumer incomes, and income tax payments.

DISTRIBUTION OF CONSUMER EXPENDITURES

Table 1 shows the distribution, by income class, of average family expenditures on the seven taxed commodities. The income and expenditure data in the table were taken from the 1982-1983 Consumer Expenditure Survey (CES) Interview Survey and have been aged to 1985 using the growth rate in per capita expenditures and per capita income between 1982-1983 and 1985.[1]

Taxable Expenditures as a Percent of Income

For each type of expenditure except airfare, expenditures as a percent of income fall as income rises (see the second row for each type of expenditure in Table 1). Airfare expenditures rise slightly as a percent of income for families with incomes of $40,000 or more. Expenditures for gasoline and telephone service show the largest decline in expenditures as

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[1] The 1982-1983 Consumer Expenditure Survey consists of two parts: (1) the Interview Survey in which consumer units (families) are interviewed every three months and (2) the Diary Survey in which families record their purchases over a one-week period. The interview survey is designed to obtain information on the types of expenditures that consumers can be expected to recall over a long period of time. It reports only combined expenditures for beer and wine consumed at home, and combined expenditures for all alcoholic beverages consumed away from home. Factors derived from the diary survey in which separate expenditures for beer, wine, and distilled spirits are reported both for consumption at home and away, are used to allocate the combined alcoholic beverage expenditures reported in the interview survey. For more information on the complete 1982-1983 survey, see Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey: Interview Survey, 1982-1983, Bulletin 2246; and Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey: Diary Survey, 1982-1983, Bulletin 2245.

TABLE 1. AVERAGE INCOME, AVERAGE TOTAL EXPENDITURES, AND AVERAGE EXPENDITURES SUBJECT TO FEDERAL EXCISE TAX, BY INCOME CLASS, 1985

	All Incomes	Less Than $5,000	$5,000- $9,999	$10,000- $19,999	$20,000- $29,999	$30,000- $39,999	$40,000- $49,999	$50,000 Or More
Average Income ($)	26,602	2,311	7,401	14,764	24,750	34,630	44,539	72,016
Share of Total Income (%)	100.0	0.8	4.1	13.3	17.1	17.6	14.1	33.0
Average Total Expenditures ($)	22,828	9,690	10,838	16,196	22,514	27,892	34,007	47,382
Share of Total Expenditures (%)	100.0	3.8	7.0	17.0	18.0	16.4	12.6	26.2
Average Gasoline Expenditures ($)	995	394	453	801	1,111	1,309	1,459	1,639
As a % of income	3.75	17.04	6.12	5.42	4.49	3.78	3.28	2.28
As a % of all expenditures	4.36	4.06	4.18	4.94	4.93	4.69	4.29	3.46
Share of Gasoline Expenditures (%)	100.0	3.6	6.7	19.2	20.4	17.7	12.3	20.0
Average Beer Expenditures ($)	310	159	157	266	341	414	399	472
As a % of income	1.17	6.88	2.12	1.80	1.38	1.19	0.90	0.66
As a % of all expenditures	1.36	1.64	1.44	1.64	1.51	1.48	1.17	1.00
Share of Beer Expenditures (%)	100.0	4.7	7.6	20.5	20.1	17.9	10.8	18.5
Average Wine Expenditures ($)	72	32	30	53	70	89	108	154
As a % of income	0.27	1.38	0.40	0.36	0.28	0.26	0.24	0.21
As a % of all expenditures	0.32	0.33	0.27	0.33	0.31	0.32	0.32	0.32
Share of Wine Expenditures (%)	100.0	4.1	6.1	17.4	17.7	16.5	12.6	26.8
Average Liquor Expenditures ($)	197	88	88	150	203	254	267	381
As a % of income	0.74	3.81	1.19	1.02	0.82	0.73	0.60	0.53
As a % of all expenditures	0.86	0.91	0.81	0.93	0.90	0.91	0.79	0.80
Share of Liquor Expenditures (%)	100.0	4.1	6.6	18.2	18.9	17.3	11.4	23.6
Average Tobacco Expenditures ($)	344	182	247	318	394	441	435	390
As a % of income	1.30	7.88	3.33	2.15	1.59	1.27	0.98	0.54
As a % of all expenditures	1.51	1.88	2.27	1.96	1.75	1.58	1.28	0.82
Share of Tobacco Expenditures (%)	100.0	4.8	10.6	22.1	20.9	17.2	10.6	13.8
Average Telephone Expenditures ($)	432	284	305	384	435	500	532	641
As a % of income	1.63	12.30	4.12	2.60	1.76	1.44	1.20	0.89
As a % of all expenditures	1.89	2.93	2.82	2.37	1.93	1.79	1.57	1.35
Share of Telephone Expenditures (%)	100.0	6.0	10.4	21.3	18.4	15.5	10.4	18.0
Average Airfare Expenditures ($)	201	67	64	134	174	204	299	573
As a % of income	0.76	2.91	0.87	0.90	0.70	0.59	0.67	0.80
As a % of all expenditures	0.88	0.69	0.59	0.82	0.77	0.73	0.88	1.21
Share of Airfare Expenditures (%)	100.0	3.0	4.7	15.9	15.8	13.6	12.6	34.5

SOURCE: CBO tabulations based on data from the Consumer Expenditure Survey: Interview Survey, 1982-1983. Income and expenditure data have been aged to 1985 and adjusted for underreporting of taxable expenditures.

a percent of income between the lowest and highest income classes. Families with incomes of less than $5,000 spend 17 percent of their income on gasoline, compared with just over 2 percent for families with incomes of $50,000 or more. Families in the lowest income class spend about 12 percent of their income on telephone service; families in the highest income class spend just under 1 percent.

Taxable Expenditures as a Percent of Total Expenditures

Expenditures are shown as a percentage of total expenditures as well as a percentage of income. Because income is measured over a single year, expenditures expressed as a percent of income may overstate the fraction of permanent income spent on that good. Families whose income may have fallen temporarily are likely to maintain their previous level of consumption in the expectation that their income will return to normal levels.[2] Because total expenditures are generally thought to reflect long-term incomes, total expenditures may be a better measure of a family's permanent economic condition than income from a single year. Expenditures on each item expressed as a percentage of total expenditures may better approximate the fraction of income spent on each good over a longer time period.

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[2] Because 1982 and 1983 were years of high unemployment, this may be particularly true for the data presented in the table. The comparison of expenditures and income is further complicated by the survey design. Families were interviewed every three months over a 12-month period about their expenditures during the previous three months. Each interview is treated as a separate observation in the table. Income information was collected at the beginning and the end of the 12-month cycle about income received in the previous 12 months. Thus, for many observations, reported expenditures may have occurred just after the period during which reported income was received.

Expenditures for all seven items are much more constant across income classes when measured as a percentage of total expenditures rather than as a percentage of total income. Expenditures for liquor and wine vary little among income classes; gasoline, beer, and airfare expenditures are almost constant except for the highest income class, with airfare differing from the other two items in that the percentage of total expenditures increases rather than decreases for families with incomes of $50,000 or more. Tobacco and telephone expenditures measured as a percentage of total expenditures retain the observed pattern when measured as a percentage of income, declining as income rises. However, smaller differences exist between the highest and lowest income groups when measured relative to total expenditures than to income.

The difference between the distribution of taxable expenditures measured as a percentage of income and of total expenditures is best illustrated by the distribution of gasoline expenditures. Gasoline expenditures as a fraction of income fall sharply as income rises. When measured as a fraction of total expenditures, however, gasoline expenditures are mostly constant across income classes, falling slightly in both the highest and lowest groups. Thus, a tax on gasoline would impose a heavy one-year burden on any family whose income is low in a certain year, but the long-term burden would be more nearly the same for most families, to the extent that total expenditures reflect long-term family incomes.

Methods for Computing Taxable Expenditures

To facilitate comparison of expenditures for the different items, expenditures were adjusted for underreporting. The proportion of total consumer expenditures reported on the survey varies by the type of expenditure. For example, after adjusting the data to reflect the growth in per capita expenditures for each type of expenditure between 1982-1983 and 1985, expenditures reported on the survey for wine, gasoline, and telephone services were consistent with the total amount spent on those items in 1985 by the percentage of the population represented by the survey sample. However, beer expenditures were less than one-third the amount that should have been reported. If the data were not adjusted for underreporting, taxes on beer expenditures would appear to be a much smaller percentage of income and total expenditures than taxes on expenditures for which there was more complete reporting. To correct for this, all expenditure amounts were adjusted to reflect 1985 total consumer expenditures for those items as reported in the Survey of Current Business.3/

Total income is measured as the sum of wages and salaries, self-employment income, rents, interest, dividends, pensions, Social Security

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3. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business vol. 66, no. 7, July 1986. The Survey of Current Business does not report separate expenditures for beer, wine, and distilled spirits. The total expenditure for alcoholic beverages, including purchases for on- and off-premise consumption, was divided among the three types of expenditures using factors of 53.4 percent for beer, 12.5 percent for wine, and 34.1 percent for distilled spirits. These factors were derived from estimates by the Distilled Spirits Council of the U.S., Inc., of total expenditures in 1985 on beer, wine, and distilled spirits.

benefits, and other social insurance payments.[4] Total expenditures are measured as the sum of all expenditures reported on the survey including employee contributions for pensions and Social Security. Total expenditures were not adjusted for underreporting but include the adjustments made to the separate expenditures listed in Table 1. Families are defined as one or more members of the same household who either are related or make joint decisions on expenditures.

Neither the aging of the data to 1985 nor the adjustments for underreporting change the distribution of expenditures by income class. The distribution retains the same characteristics as in the original data for 1982-1983. Thus the data in Table 1 would not capture either shifts in the distribution of expenditures since that time or a pattern of underreporting of expenditures that differs by income class.

Shares of Taxable Expenditures

Another way to compare the distribution of different expenditures by income class is to look at the share of expenditures of that type in each income class (see the fourth row for each type of expenditure in Table 1). Because the classes differ in size, expenditure shares would not be equally divided among classes even if all families spend the same amount. However, one can compare the share of expenditures of a particular type for an income class with the share of total expenditures for that class. By this measure, families with incomes under $10,000 account for a much larger share of tobacco and telephone expenditures and a slightly larger share of beer expenditures than their share of total expenditures. Conversely, for all commodities except wine and airfare, the share of expenditures for families with incomes of $40,000 or more is less than their share of total expenditures.

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[4] Income in the highest income category was adjusted for topcoding. To maintain confidentiality, reported amounts of income of any type in excess of $75,000 for data collected in 1982 or $100,000 for data collected in 1983 were replaced with those amounts. Total income is the sum of those components and may include topcoded amounts. Total income for families in which some component of income was topcoded was adjusted using aggregate tax return data for high-income families for those years.

Distribution of Expenditures within Income Classes

The distribution of average expenditures across income classes hides important differences within each income class. First, not all families within a particular income class purchase all of the items. The percentage of families that do make expenditures is likely to be different at different income levels. Second, even for families that do make expenditures, the amount of expenditures may vary as much within each class as among classes.

The discretionary nature of some of the expenditures can be seen in Table 2, which shows the distribution, by income, of the percent of families with expenditures, average expenditures for families with expendi-

TABLE 2. AVERAGE EXPENDITURES FOR FAMILIES WITH EXPENDITURES SUBJECT TO FEDERAL EXCISE TAX, BY INCOME CLASS, 1985

	All Incomes	Less Than $5,000	$5,000-$9,999	$10,000-$19,999	$20,000-$29,999	$30,000-$39,999	$40,000-$49,999	$50,000 Or More
Families with Gasoline Expenditures								
Percent of all families	81.6	62.0	71.4	93.0	98.7	99.6	99.4	100.0
Average gasoline expenditures	1,144	667	578	821	1,215	1,304	1,481	1,709
Percent within 50% of the average	66.1	43.6	43.8	64.5	70.7	69.7	72.2	67.2
Families with Beer Expenditures								
Percent of all families	72.0	34.3	44.6	68.3	80.3	78.8	84.9	91.6
Average beer expenditures	414	265	323	368	432	548	370	436
Percent within 50% of the average	38.0	24.2	31.4	33.0	36.5	36.8	42.4	51.7
Families with Wine Expenditures								
Percent of all families	72.0	34.3	44.6	68.3	80.3	78.8	84.9	91.6
Average wine expenditures	103	44	55	64	85	117	117	107
Percent within 50% of the average	38.1	21.1	32.5	33.2	36.4	37.2	41.4	51.6
Families with Liquor Expenditures								
Percent of all families	66.1	25.6	38.4	59.8	74.0	73.9	82.7	89.8
Average liquor expenditures	290	213	196	212	206	378	268	423
Percent within 50% of the average	36.1	25.6	28.6	32.8	37.2	32.0	36.1	47.9
Families with Tobacco Expenditures								
Percent of all families	50.1	37.0	40.2	51.5	64.2	65.1	60.9	60.3
Average tobacco expenditures	667	480	535	589	690	760	719	716
Percent within 50% of the average	58.8	57.7	57.7	56.1	65.0	61.0	56.8	53.5
Families with Telephone Expenditures								
Percent of all families	98.4	90.8	96.3	98.6	99.1	99.8	99.8	99.3
Average telephone expenditures	447	311	308	389	446	486	526	660
Percent within 50% of the average	65.6	59.0	66.0	60.6	62.2	72.8	71.3	70.1
Families with Airfare Expenditures								
Percent of all families	24.4	9.5	7.4	17.8	22.3	29.2	31.1	54.4
Average airfare expenditures	829	434	463	700	790	787	990	976
Percent within 50% of the average	48.9	51.9	57.7	53.5	54.1	52.7	40.6	42.2

SOURCE: CBO tabulations based on data from Consumer Expenditure Survey: Interview Survey, 1982-1983. Income and expenditure data have been aged to 1985 and adjusted for underreporting of taxable expenditures. Expenditure information is given only for families with four consecutive quarters of expenditures.

tures, and the percentage of families with expenditures who spend within 50 percent of the average for that income class.5/

Almost all families make expenditures on gasoline and telephone service, between two-thirds and three-fourths of families spend money on various alcoholic beverages, about one-half purchase tobacco products, and less than one-quarter have expenditures on airfare. The percentage of families with expenditures varies by income. The greatest differences in the percentage of families with expenditures are for alcoholic beverages and airfare, while the least difference is for telephone service.

There are also differences among types of expenditures in the variation of expenditures around the mean. Almost two-thirds of gasoline and telephone expenditures fall within 50 percent of the average expenditure (between $572 and $1,716 for gasoline and between $224 and $671 for telephone). However, less than 40 percent of alcoholic beverage expenditures are within 50 percent of the average.

The dispersion of expenditures within income classes is further illustrated by Figures 1 and 2. Figure 1 shows the share of expenditures on tobacco, gasoline, and telephone services made by the bottom 50 percent of families within each income class, where families are ordered according to the amount of their expenditures on each item. Figure 2 shows the share of expenditures made by the top 20 percent of families.

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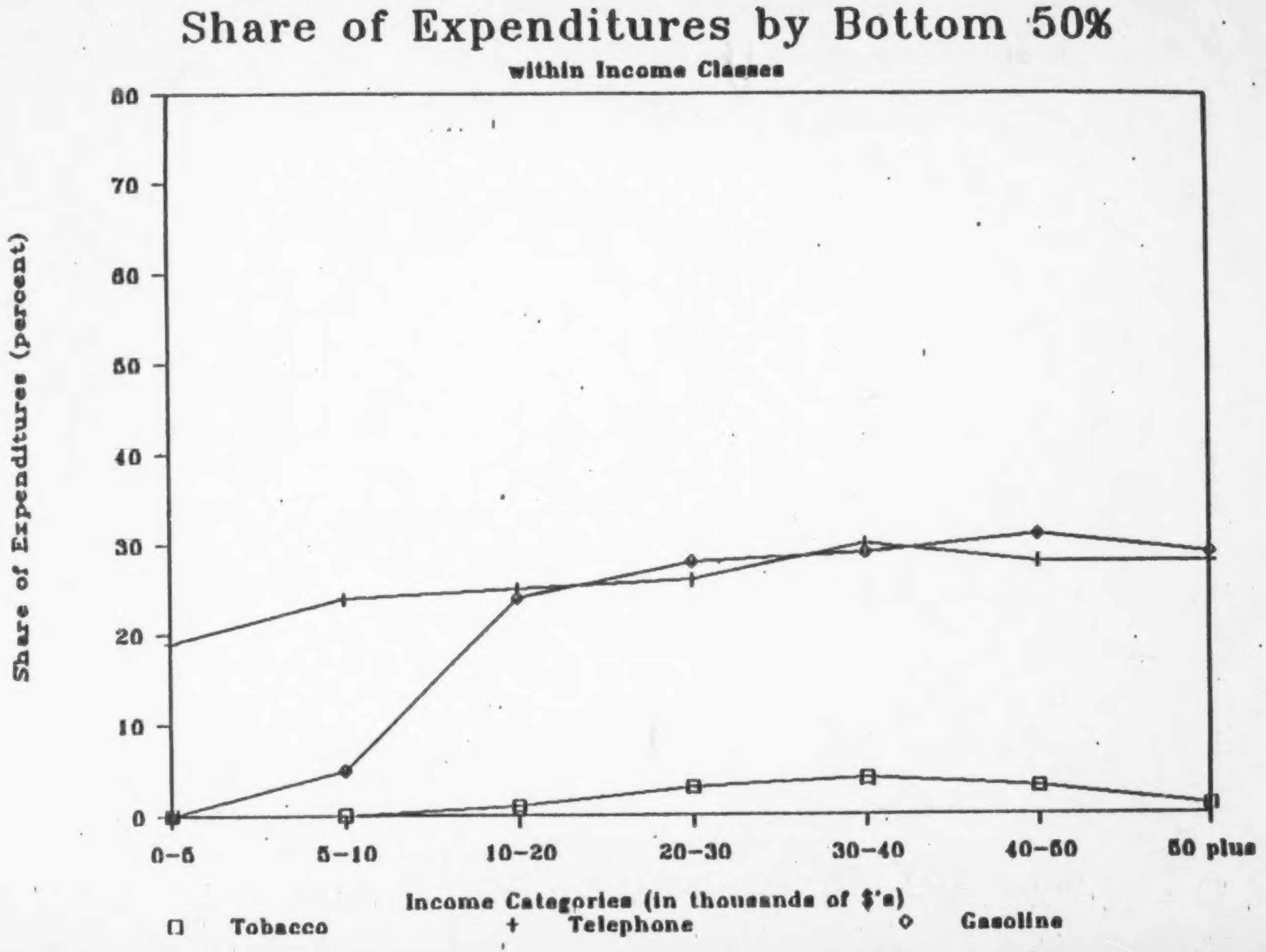
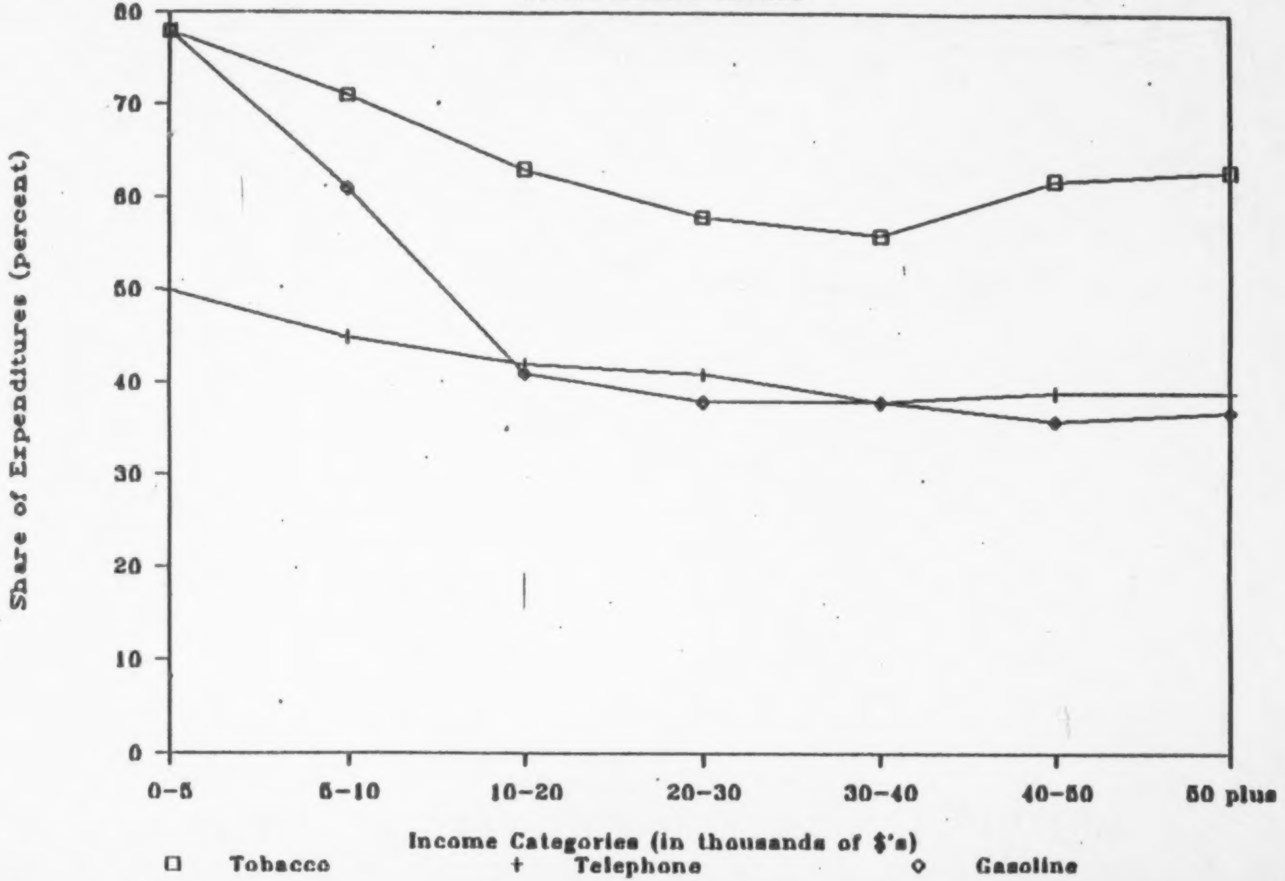
5. To eliminate variations caused by quarter-to-quarter fluctuations in spending, only data for families with four consecutive quarters of expenditure information were used in constructing Table 2.


Share of Expenditures by Bottom 50%
within Income Classes
Share of Expenditures (percent)
80
70
60
50
40
30
20
10
0
0-5
5-10
10-20
20-30
30-40
40-50
50 plus
Income Categories (in thousands of $'s)
□ Tobacco
+ Telephone
◇ Gasoline

Share of Expenditures by Top 20%

within Income Classes



Because expenditures for telephone services do not vary a great deal among families with the same incomes, except for families in the lowest income class, the lines indicating shares of expenditures for telephone services are nearly horizontal. Within each income class, the 50 percent of families who spend the least on telephone service make about 25 percent to 30 percent of the expenditures, while the 20 percent who spend the most make about 40 percent of the expenditures.

In contrast, expenditures for tobacco vary a great deal within each income class, with the greatest dispersion among low-income families. Within each income class, about 50 percent of families purchase almost no tobacco. Among low-income families, the 20 percent of families who spend the most on tobacco make about 75 percent of all tobacco purchases, while among middle-income families, the 20 percent who spend the most make between 55 percent and 60 percent of tobacco purchases.

The lines showing expenditure shares for gasoline have a pattern similar to those for telephone services for families with incomes of $10,000 or more; above that level of income, families with the same income spend roughly the same amount on gasoline. However, for low-income families, there is greater divergence in gasoline expenditures.

These results suggest that the incidence of excise taxes within income classes varies a great deal. This variation may be appropriate for excise taxes that are intended to penalize or discourage the purchase of certain commodities and for excise taxes designed primarily as user fees.

For example, taxes on tobacco and alcoholic beverages serve to discourage consumption of those items and revenues from the gasoline excise tax go into the Highway Trust Fund, which is used to finance the construction and repair of federal highways. However, differences in the amount of expenditures for certain items result in a tax burden from selective excise taxes that is less horizontally equitable than a tax on more broadly based consumption. With selective excise taxes, families in nearly identical economic circumstances can pay very different amounts of tax.

DISTRIBUTION OF EXCISE TAX LIABILITIES

Table 3 shows the distribution of excise tax liabilities by income class. Tax liabilities were calculated by CBO based on the taxable expenditure data presented in the previous section.

Taxes as a Percent of Income

As a percentage of income, taxes are highest in the lowest income class for all seven types of expenditures. Taxes as a percentage of income fall by about one-half for most types of expenditures between families with incomes of $10,000 to $20,000 and families with incomes of $50,000 or more. However, tobacco taxes as a percent of income are less than one-fourth as large for families in the highest income class compared to families with incomes of $10,000 to $20,000.

	All Incomes	Less Than $5,000	$5,000- $9,999	$10,000- $19,999	$20,000- $29,999	$30,000- $39,999	$40,000- $49,999	$50,000 Or More
Average Combined Excise Tax ($)	252	113	129	201	267	317	353	429
As a % of income	0.95	4.89	1.74	1.36	1.08	0.92	0.79	0.61
As a % of all expenditures	1.10	1.17	1.19	1.24	1.18	1.14	1.04	0.93
Share of Combined Excise Tax	100.0	4.1	7.6	19.1	19.4	16.9	11.8	21.2
Average Gasoline Excise Tax ($)	93	37	43	73	102	121	137	161
As a % of income	0.35	1.62	0.58	0.50	0.41	0.35	0.31	0.22
As a % of all expenditures	0.41	0.39	0.39	0.45	0.45	0.43	0.40	0.34
Share of Gasoline Excise Tax	100.0	3.6	6.8	18.8	20.0	17.4	12.4	21.0
Average Beer Excise Tax ($)	17	9	9	14	19	23	23	28
As a % of income	0.06	0.37	0.12	0.10	0.07	0.07	0.05	0.04
As a % of all expenditures	0.08	0.09	0.08	0.09	0.08	0.08	0.07	0.06
Share of Beer Excise Tax	100.0	4.5	7.4	19.8	19.7	17.6	11.2	19.8
Average Wine Excise Tax ($)	4	2	2	3	4	5	6	8
As a % of income	0.01	0.07	0.02	0.02	0.02	0.01	0.01	0.01
As a % of all expenditures	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
Share of Wine Excise Tax	100.0	4.0	6.3	17.3	17.8	16.5	12.5	26.7
Average Liquor Excise Tax ($)	39	17	18	29	40	50	54	76
As a % of income	0.15	0.75	0.24	0.20	0.16	0.14	0.12	0.11
As of % of all expenditures	0.17	0.18	0.16	0.18	0.18	0.18	0.16	0.16
Share of Liquor Excise Tax	100.0	4.0	6.7	18.0	18.7	17.1	11.6	23.9
Average Tobacco Excise Tax ($)	46	24	33	42	52	58	58	52
As a % of income	0.17	1.05	0.44	0.29	0.21	0.17	0.13	0.07
As a % of all expenditures	0.20	0.25	0.30	0.26	0.23	0.21	0.17	0.11
Share of Tobacco Excise Tax	100.0	4.8	10.6	22.1	20.9	17.2	10.5	13.8
Average Telephone Excise Tax ($)	26	14	15	21	26	32	36	47
As a % of income	0.10	0.61	0.21	0.14	0.11	0.09	0.08	0.07
As a % of all expenditures	0.12	0.15	0.14	0.13	0.12	0.11	0.11	0.10
Share of Telephone Excise Tax	100.0	4.8	8.6	19.0	18.2	16.0	11.5	21.8
Average Airfare Excise Tax ($)	27	10	10	18	24	29	30	67
As a % of income	0.10	0.43	0.14	0.12	0.10	0.08	0.09	0.09
As a % of all expenditures	0.12	0.10	0.09	0.11	0.11	0.10	0.12	0.14
Share of Airfare Excise Tax	100.0	3.4	5.7	16.3	16.8	14.8	12.5	30.5

SOURCE: CBO tabulations based on data from Consumer Expenditure Survey: Interview Survey, 1982-1983. Income and expenditure data have been aged to 1985 and adjusted for underreporting of taxable expenditures. Taxes include indirect excise tax liabilities.

Taxes as a Percent of Total Expenditures

Taxes are more nearly constant across all income classes as a percent of expenditures than as a percent of income (see the third and second rows, respectively, for each type of tax in Table 3). When measured as a percent of total expenditures, however, tobacco taxes still fall by more than one-half between families with incomes of $10,000 to $20,000 and families with incomes of $50,000 or more. Telephone taxes measured as a percent of total expenditures decline gradually as income rises.

Methods for Computing Excise Tax Liabilities

Excise taxes for gasoline, beer, wine, distilled spirits, and tobacco are levied on a per unit basis where the tax rate is a fixed amount per unit of sale. For example, gasoline is taxed at $.09 per gallon, cigarettes at $.16 per pack of 20 cigarettes, beer at $.29 per gallon, distilled spirits at $12.50 per gallon, and wine at rates ranging from $.17 to $3.40 per gallon. Excise taxes on airline tickets and telephone service are levied on an *ad valorem* basis in which the tax is expressed as a constant fraction of the price of the commodity. The tax rate for local and long-distance telephone service is 3 percent of the amount paid; for air passenger tickets, 8 percent of the airfare.[6]

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[6] The tax rate for air passenger tickets is 8 percent of the airfare for domestic travel, but $3.00 per person for international departures. The data were treated as if all expenditures for air travel were for domestic flights.

The data used for this study do not identify the quantity of each item purchased. Rather, they indicate only how much was spent on a particular commodity. While this was not a problem for *ad valorem* taxes, it was necessary to convert unit tax rates to *ad valorem* tax rates.

Because of the lack of comprehensive price data for beer, wine, and distilled spirits, and because of the varying unit tax rates on different types of wine and, to a lesser degree, on different types of tobacco purchases, the unit tax rate for these items could not be converted directly to an *ad valorem* rate. Rather, the tax rate for these commodities as a percent of the total price was computed as the ratio of total excise tax revenue to total expenditures. For gasoline, the *ad valorem* tax rate was computed as the ratio of the tax rate of $.09 per gallon of gasoline divided by an average price per gallon of $1.18.

Using these *ad valorem* tax rates, the amount of excise tax payments was calculated for each type of taxable expenditure. Purchasers of taxed goods were assumed to pay the full amount of the excise tax through higher prices.

The major drawback in using a single *ad valorem* rate for goods with a unit tax is that it implicitly assumes that all families pay the same price for purchases of the taxed items. This assumption is most troublesome for those expenditures in which there may be large differences in the quality of the item purchased. For example, all wine purchases are assumed to be taxed at the same rate whether the wine sells for $2 or $20 a bottle. A single *ad valorem* tax rate for all wine expenditures will overstate the taxes paid by consumers who purchase wine at prices greater than the average and will understate taxes for those who purchase wine that is less expensive than average. If higher-income households generally purchase goods of higher quality, the assumption that an excise tax is proportional to expenditures on those goods will cause the tax to appear less regressive than it actually is.

Some portion of the total expenditure for certain commodities is made by business purchasers. The CBO analysis assumed that the ultimate incidence of the excise taxes for these purchases was borne by consumers. Thus, for example, gasoline taxes paid in the course of transporting other commodities were assumed to be reflected in the price consumers paid for those goods. The share of excise taxes paid by businesses was distributed to consumers in proportion to the total expenditures of each family.[7]

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[7] In making these computations, business expenditures were assumed to be approximately [illegible] percent of total expenditures--excluding purchases made by the government--for beer, wine, distilled spirits, and gasoline, 50 percent for telephone service, and 43 percent for airfare. All tobacco expenditures were assumed to have been made by consumers. The business shares of total expenditures on beer, wine, and distilled spirits were based on estimates by the Distilled Spirits Council of the U.S., Inc., of the business share of total alcoholic beverage expenditures in 1984. The business shares of total expenditures on gasoline, telephone service, and airfare were based on the implied level of total expenditures in calendar year 1985 calculated by dividing excise tax revenues by the excise tax rate.

Shares of Excise Tax Liabilities

In general, the distribution of the share of taxes paid by each income class should look similar to the distribution of the share of family expenditures for each item. However, for those commodities where a larger percentage of the purchases are made by businesses, the distribution of the share of excise taxes paid will look more like the distribution of total family expenditures than the distribution of family expenditures on that item alone.

The fourth row for each type of expenditure in Table 3 shows the share of taxes paid by each income class. These shares reflect both the share of expenditures on the particular item and the share of total expenditures. Thus, although families with income of less than $10,000 accounted for 16.4 percent of direct telephone expenditures, the share of the telephone excise tax paid by these families was actually 13.4 percent when telephone expenditures by businesses are factored in.

Families with incomes of less than $10,000 pay at least 10 percent to 12 percent of excise taxes on gasoline and alcoholic beverages. These families pay about 13 percent of the telephone excise tax and about 15 percent of the tax on tobacco. Families in the highest income class pay between 20 percent and 25 percent of most excise taxes except those for airfare (31 percent) and tobacco (only 14 percent).

DISTRIBUTION OF EXCISE TAX INCREASES

This section traces the distributional effects of a $1 billion increase in excise tax revenues generated through increases in each of the excise taxes. The distributional results for a change in excise taxes reflect the distribution of expenditures and taxes previously presented.

The Congressional Budget Office has assumed that the full tax increase initially is passed forward to consumers through an increase in prices.[8] With no change in the quantity purchased, expenditures on the taxed commodities increase by the full amount of the tax increase. Because of the assumption that people buy less of most items when taxes on those items increase, expenditures increase by less than the full amount of the tax increase for goods with price elasticities other than zero.[9] The percentage increase in tax rates for these goods therefore must exceed the percentage increase in tax revenues to generate the additional $1 billion in gross revenues.

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[8] An alternative assumption is that the tax increase is fully or partially shifted to factor incomes of producers of the taxed goods through reduced wages and dividends and that, consequently, there is no change or only a partial increase in prices. Because producers of the taxed commodities operate in generally competitive labor and capital markets, the tax increase probably could not be shifted to factor incomes. Other analysts have suggested that an excise tax increase would cause prices to rise by more than the amount of the tax increase because the tax is treated as a cost of production and producers follow a strategy of setting prices at some markup over costs. Such a price increase would not be stable, however, unless prices were below their optimal level before the imposition of the tax increase.

[9] A price elasticity of -1.00 was used for airfare, -0.80 for distilled spirits, -0.40 for beer, wine, and tobacco products, -0.20 for gasoline, and 0.00 for telephone service. The price elasticity for tobacco products is consistent with recent empirical findings: see, for example, Eugene M. Lewit and Douglas Coate, "The Potential for Using Excise Taxes to Reduce Smoking," Journal of Health Economics, no. 1 (1982), pp. 121-145, who report a price elasticity for cigarettes of -0.42. The elasticity for beer is within the range found by Stanley I. Ornstern and David Levy, "Price and Income Elasticities and the Demand for Alcoholic Beverages," in Marc Galtner, ed., Recent Developments in Alcoholism, vol. I (New York: Plenum Press, 1983), pp. 303-345, who report an average price elasticity for beer of between -0.30 and -0.40. However, they also report an average price elasticity for distilled spirits of between -1.00 and -2.00. Rather than

Although a different elasticity was used for each tax increase, for any single tax increase the same elasticity value was used for all families. Thus, the distributional results are unaffected by the introduction of price elasticities. Using a constant price elasticity for each of the tax increases would only affect the percentage increase in tax rates necessary to generate an additional $1 billion in gross excise tax revenue. Actual distributional outcomes would differ from the simulated results if the response to an increase in excise taxes varied among families in relation to their income.

Table 4 shows excise tax liabilities in calendar year 1985 for the seven types of taxes and the percentage increase in tax rates necessary to produce an additional $1 billion in gross excise tax revenues from each of the taxes considered separately. The percentage increase in tax rates is shown with and without adjustments for a decrease in the quantity of the item purchased.

The increase in average excise tax liabilities with an alternative $1 billion increase in gross revenues from each of the seven excise taxes is shown in Table 5. The increase in taxes paid by businesses that purchase

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use this result. CBO elected to use elasticities for distilled spirits, wine, airfare, gasoline, and telephone service that reflect estimates used by the Department of Treasury.

Table 4. Tax Revenues and Tax Increases Necessary to Generate an Additional $1 Billion in Gross Excise Tax Revenues, 1985

Type of Tax	Calendar Year 1985 Excise Tax Liabilities (Billions of dollars)	Percentage Increase in Tax Rate Necessary to Produce an Additional $1 Billion in Gross Tax Revenues: Without Quantity Response	Percentage Increase in Tax Rate Necessary to Produce an Additional $1 Billion in Gross Tax Revenues: With Quantity Response
Gasoline	8.60	11.6	11.8
Beer	1.59	62.9	64.8
Wine	0.36	280.5	301.0
Distilled Spirits	3.60	27.8	33.4
Tobacco	4.22	23.7	25.4
Telephone	2.45	40.9	40.9
Airfare	2.45	40.9	45.8

SOURCE: Congressional Budget Office.

the taxed goods have been distributed to consumers in proportion to their total expenditures. Thus all taxes generate the same average increase in tax payments.

With a simulated $1 billion increase in gross excise tax revenues, the average tax increases would be small--approximately $11 per family--or about .04 percent of total income and .05 percent of total expenditures. For the lowest income class, the tax increase from any of the taxes considered would be between 0.2 percent and 0.3 percent of income, and less than 0.1 percent of total expenditures.

Using a measure of the tax increase as a percent of total expenditures, the results suggest that, except for an increase in the tobacco tax, there would not be strong reasons to prefer one tax increase over another

TABLE 5. CHANGE IN AVERAGE EXCISE TAX FOR ALL FAMILIES, BY INCOME CLASS, 1985

	All Incomes	Less Than $5,000	$5,000- $9,999	$10,000- $19,999	$20,000- $29,999	$30,000- $39,999	$40,000- $49,999	$50,000 Or More
Increase in Gasoline Excise Tax ($)	11	4	5	9	12	14	16	19
As a % of income	0.04	0.19	0.07	0.06	0.05	0.04	0.04	0.03
As a % of all expenditures	0.05	0.04	0.06	0.05	0.05	0.05	0.05	0.04
Share of Gasoline Tax Increase	100.0	3.6	6.8	18.8	20.0	17.4	12.4	21.0
Increase in Beer Excise Tax ($)	11	5	5	9	12	14	14	18
As a % of income	0.04	0.23	0.07	0.06	0.05	0.04	0.03	0.02
As a % of all expenditures	0.06	0.05	0.05	0.06	0.05	0.05	0.04	0.04
Share of Beer Tax Increase	100.0	4.5	7.4	19.8	19.7	17.6	11.2	19.8
Increase in Wine Excise Tax ($)	11	6	5	8	11	13	16	23
As a % of income	0.04	0.20	0.06	0.05	0.04	0.04	0.04	0.03
As a % of all expenditures	0.05	0.05	0.04	0.05	0.05	0.05	0.05	0.06
Share of Wine Tax Increase	100.0	4.0	6.3	17.3	17.8	16.5	12.5	25.7
Increase in Liquor Excise Tax ($)	11	5	5	8	11	14	15	21
As a % of income	0.04	0.21	0.07	0.06	0.04	0.04	0.03	0.03
As a % of all expenditures	0.05	0.05	0.05	0.06	0.05	0.05	0.04	0.04
Share of Liquor Tax Increase	100.0	4.0	6.7	18.0	18.7	17.1	11.6	23.9
Increase in Tobacco Excise Tax ($)	11	6	8	10	12	14	14	12
As a % of income	0.04	0.25	0.10	0.07	0.05	0.04	0.03	0.02
As a % of all expenditures	0.05	0.06	0.07	0.06	0.05	0.05	0.04	0.03
Share of Tobacco Tax Increase	100.0	4.8	10.6	22.1	20.9	17.2	10.6	13.8
Increase in Telephone Excise Tax ($)	11	6	6	9	11	13	15	19
As a % of income	0.04	0.25	0.09	0.06	0.04	0.04	0.03	0.03
As a % of all expenditures	0.05	0.06	0.06	0.05	0.05	0.05	0.04	0.04
Share of Telephone Tax Increase	100.0	4.8	8.6	19.0	18.2	16.0	11.5	21.8
Increase in Airfare Excise Tax ($)	11	4	4	7	10	12	16	27
As a % of income	0.04	0.18	0.06	0.05	0.04	0.03	0.04	0.04
As a % of all expenditures	0.05	0.04	0.04	0.05	0.04	0.04	0.05	0.06
Share of Airfare Tax Increase	100.0	3.4	5.7	16.3	16.8	14.8	12.5	30.5

SOURCE: CBO simulations based on data from Consumer Expenditure Survey: Interview Survey, 1982-1983. Income and expenditure data have been aged to 1985 and adjusted for underreporting of taxable expenditures. Taxes include indirect excise tax liabilities.

on distributional grounds. An increase in the tax on telephone service would raise the tax burden on low-income families by slightly more than would increases in the tax on gasoline or alcoholic beverages, while an increase in the tax on airline tickets would raise the tax burden on high-income families by slightly more than would increases in all other taxes. An increase in the tax on tobacco would raise taxes as a percent of expenditures by more than twice as much for families with incomes below $10,000 than for families with incomes of $50,000 or more.

Within each income class, most of the burden of the tax increase would fall on those families with expenditures on the taxed items. Tax increases on expenditures for telephone services, for example, would be distributed across almost all low-income families, while tax increases on alcoholic beverages and tobacco would be distributed to only about one-third to two-fifths of families with incomes below $10,000. Table 5 shows the average increase in excise taxes for all families, not just for those families with expenditures of a particular type.

There are some differences in the share of the tax increase that would be paid by families in different income classes. The share of the tax increase for families with incomes of less than $10,000 would be the largest for tobacco taxes and the smallest for airfare taxes. Families with incomes between $10,000 and $30,000 would also fare the worst under a tobacco tax increase and fare the best under an airfare tax.

OVERALL INCIDENCE OF AN INCREASE IN EXCISE TAXES

The overall incidence of an increase in excise taxes consists of two elements: (1) a redistribution of income--from consumers who purchase the item against which the tax increase is levied, to other consumers as the price of the taxed item rises relative to the prices of other goods and services--and (2) a net decline in personal income from employment and investment.

Effect on Relative Prices

An increase in any given excise tax would increase the price of the taxed item relative to the price of other goods and services.10/ Consumers who do not purchase those items on which the excise tax is increased, or who purchase less than the average amount, would be relatively better off.

The result extends to entire income classes in which the share of expenditures on a taxed item is less than that income class's share of total expenditures. Table 6 illustrates the distribution of the increase in excise taxes offset by the decrease in the price of other goods and services. The gains from this price decrease are distributed to families in proportion to their total expenditures. Because the increase in the price of the item against which the increased excise tax is levied is offset by the relative decline in other prices, the average effect over all

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10. This change in relative price will occur whether or not absolute prices are allowed to rise by the amount of the tax increase or are held constant--for example, by an appropriate monetary policy.

TABLE 6. CHANGE IN AVERAGE EXCISE TAX WITH OFFSETTING PRICE CHANGES, BY INCOME CLASS, 1985

	All Incomes	Less Than $5,000	$5,000- $9,999	$10,000- $19,999	$20,000- $29,999	$30,000- $39,999	$40,000- $49,999	$50,000 Or More
Change in Gasoline Excise Tax ($)	0	0	0	1	1	1	0	-3
As a % of income	0.00	-0.01	0.00	0.01	0.00	0.00	0.00	-0.01
As a % of all expenditures	0.00	0.00	0.00	0.01	0.01	0.00	0.00	-0.01
Change in Beer Excise Tax ($)	0	1	0	1	1	1	-1	-4
As a % of income	0.00	0.03	0.00	0.01	0.00	0.00	0.00	-0.01
As a % of all expenditures	0.00	0.01	0.00	0.00	0.00	0.00	-0.01	-0.01
Change in Wine Excise Tax ($)	0	0	0	0	0	0	0	0
As a % of income	0.00	0.01	-0.01	0.00	0.00	0.00	0.00	0.00
As a % of all expenditures	0.00	0.00	-0.01	0.00	0.00	0.00	0.00	0.00
Change in Liquor Excise Tax ($)	0	0	0	0	0	1	0	0
As a % of income	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.00
As a % of all expenditures	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00
Change in Tobacco Excise Tax ($)	0	1	3	2	2	1	-1	-9
As a % of income	0.00	0.05	0.04	0.02	0.01	0.00	-0.01	-0.01
As a % of all expenditures	0.00	0.01	0.02	0.01	0.01	0.00	-0.01	-0.02
Change in Telephone Excise Tax ($)	0	1	1	1	0	0	0	-2
As a % of income	0.00	0.06	0.02	0.01	0.00	0.00	0.00	0.00
As a % of all expenditures	0.00	0.01	0.01	0.01	0.00	0.00	0.00	-0.01
Change in Airfare Excise Tax ($)	0	0	0	0	0	0	0	5
As a % of income	0.00	-0.02	-0.01	0.00	0.00	0.00	0.00	0.01
As a % of all expenditures	0.00	-0.01	-0.01	0.00	0.00	0.00	0.00	0.01

SOURCE: CBO simulations based on data from Consumer Expenditure Survey: Interview Survey, 1982-1983. Income and expenditure data have been aged to 1985 and adjusted for underreporting of taxable expenditures. Taxes include indirect excise tax liabilities.

families would be zero. Families in those income classes that spend relatively less on the taxed item would gain on average; families in income classes that spend relatively more would lose. However, because of the relatively small changes in average taxes associated with a $1 billion increase in gross excise tax revenues, the absolute size of the gains and losses would be small.

As the table shows, families in the highest income class either would be unaffected or would gain on average because of the change in relative prices resulting from an increase in any of the excise taxes except the airline ticket tax. This result occurs because families with income of $50,000 or more have a larger share of total expenditures than of expenditures for any of the taxed items except airfare. Families in the lowest income class would lose on average because of the change in relative price resulting from an increase in the tax on tobacco and telephone service, because their share of these expenditures is larger than their share of total expenditures.

Effect on Consumer Incomes and Income Tax Payments

An increase in an excise tax not only would affect relative prices but would reduce consumer incomes as well. CBO has assumed that a tax increase would not change the gross national product. In this case, an increase in excise tax payments would reduce the amount of business receipts that can be paid out in wages and returns to shareholder investments by the amount of the tax increase. With a reduction in these payments, the aggregate income of workers and investors in the economy will fall by the amount of the tax. This decline in personal income would have certain distributional implications. First, personal income from indexed transfer payments, such as Social Security or Supplemental Security Income (SSI) benefits, would not be affected. Second, a reduction in income would reduce income tax revenues, offsetting some of the increase in excise tax revenues.

The distribution of the reduction in income and the distribution of the income tax offsets produced by a $1 billion increase in gross excise tax revenues are shown in Table 7. The reductions in income have been allocated in proportion to family income excluding Social Security and SSI benefits. Income tax offsets have been computed at the average marginal income tax rate for each income class.11/

Families in the highest income class would have the greatest share of the reduction in income, about 37 percent, but also the greatest share of the reduction in income taxes, about 48 percent. Although the income of low-income families would fall slightly, they would receive little benefit from the income tax reduction.

The combination of the effect on relative prices and the effect on consumer incomes can be illustrated for families in two different income classes using the results for an increase in the tax on tobacco. With an

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11. This reduction in income is balanced by the increase in government revenues from the increase in excise taxes. It is difficult to attribute distributional effects to the revenue increase, however, particularly if, as is likely, the money is used to reduce the federal deficit.

TABLE 7. AVERAGE INCOME REDUCTION AND AVERAGE INCOME TAX OFFSET, BY INCOME CLASS, 1985

	All Incomes	Less Than $5,000	$5,000-$9,999	$10,000-$19,999	$20,000-$29,999	$30,000-$39,999	$40,000-$49,999	$50,000 Or More
Average Reduction in Income ($)	11	1	2	5	10	15	20	32
As a % of total income	0.04	0.03	0.02	0.03	0.04	0.04	0.04	0.05
As a % of total expenditures	0.05	0.01	0.02	0.03	0.04	0.05	0.06	0.07
Share of Reduction in Income	100.0	0.6	2.2	10.4	16.4	18.4	15.3	36.6
Average Income Tax Offset ($)	3	0	0	1	2	4	6	12
As a % of total income	0.01	0.00	0.00	0.01	0.01	0.01	0.01	0.02
As a % of total expenditures	0.01	0.00	0.00	0.00	0.01	0.01	0.02	0.03
Share of Income Tax Offset	100.0	0.1	1.1	6.3	12.0	16.3	15.9	48.3

SOURCE: CBO simulations based on data from Consumer Expenditure Survey: Interview Survey, 1982-1983. Income and expenditure data have been aged to 1985 and adjusted for underreporting of taxable expenditures.

increase in tobacco taxes, families in the $10,000 to $20,000 income class would pay an average of $10 more in tobacco taxes (Table 5). However, the decline in prices of other goods and services would save families in that income class $8 on average, resulting in a net loss of $2 because of relative price changes (Table 6). Because of the decline in after-tax business receipts, the average income of families in that income class would decline by $5 (Table 7). This decline would be offset by an average reduction in income taxes of $1, resulting in a net reduction in income of $4. Thus, an increase in tobacco taxes that raises $1 billion in gross excise tax revenue would cost families in this income range an average of $6.

Compare this result with families with income between $40,000 and $50,000. The average increase in tobacco taxes for these families would be $14. After accounting for the decline in other prices, the net result would be an average gain of $1. However, the average loss in income for these families would be $20. After allowing for a $6 decline in income taxes, the net reduction in income would be $14. Thus the average cost of an increase in tobacco taxes for these families would be $13.

Because CBO has simulated a $1 billion increase in gross excise tax revenues, the absolute amount of these changes are small. A larger increase in excise taxes would produce proportionally larger average gains and losses.

increase in tobacco taxes, families in the $10,000 to $20,000 income class would pay an average of $10 more in tobacco taxes (Table 5). However, the decline in prices of other goods and services would save families in that income class $8 on average, resulting in a net loss of $2 because of relative price changes (Table 6). Because of the decline in after-tax business receipts, the average income of families in that income class would decline by $5 (Table 7). This decline would be offset by an average reduction in income taxes of $1, resulting in a net reduction in income of $4. Thus, an increase in tobacco taxes that raises $1 billion in gross excise tax revenue would cost families in this income range an average of $6.

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Because CBO has simulated a $1 billion increase in gross excise tax revenues, the absolute amount of these changes are small. A larger increase in excise taxes would produce proportionally larger average gains and losses.

These simulated distributional results for the overall incidence of the excise tax increases should not be taken too literally. A number of assumptions used in the analysis--for example, that the reduction in incomes is distributed proportionally to all factor income, or that the total gross national product remains constant--simply may not hold. As previously mentioned, the distributional results do not include the gains attributable to individual families from the way in which the government disposes of the additional tax revenues. However, the results illustrate that the overall distributional effects of the tax increase would depend not only on the distribution of expenditures on the taxed item, but also on the distribution of total expenditures and the distribution of total incomes.

Coalition Against Regressive Taxation

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1988 MAY 26 PM 12: 56

May 22, 1987

The Honorable Mitch McConnell
United States Senate
120 Russell Office Building
Washington, DC 20510

Dear Senator McConell:

Last year Congress overwhelmingly voted for tax reform, in large part to improve the fairness of the tax code. Tax reform removed six million individuals from the income tax rolls, and reduced income taxes for millions of other low- and moderate-income families.

Yet this year, some people are trying to reverse those commendable changes--not by overtly repealing low-income tax relief, but through excise tax hikes. Although a variety of rationales are presented for increasing one or another excise tax, the bottom line is this. Excise taxes are regressive. Increasing them will negate some of the most import benefits of tax reform.

A recent Congressional Budget Office study, "The Distributional Effects of an Increase in Selected Excise Taxes," looked at who pays federal taxes on beer, wine, distilled spirits, tobacco, gasoline, airfare, and telephone service. The report shows vividly how regressive these taxes are. Families with incomes below $5,000 pay from 5 to 15 times as high a percentage of income for each of these taxes as families in the $50,000-plus range pay. Taken together, these seven taxes amount to nearly 5% of income for the poorest families. The numerous state excise taxes, which often exceed federal taxes in the case of fuel, tobacco, and beverages, compound this inequity.

In short, Congress should not in good conscience entertain any proposals to increase federal excise taxes. We hope that as you weigh revenue options under the budget resolution, you will not support an increase in these unfair, regressive taxes.

The Coalition Against Regressive Taxation is an alliance of business groups representing industries that collectively pay most of the $33 billion in federal excise taxes. Our members know first hand the burden these taxes place not only on consumers but on workers in affected industries. We urge you to shun excise tax increases, for deficit reduction or other goals.

Please contact me or any of the signers listed on the next page if you would like further information.

Sincerely,

T. J. Donohue

Thomas J. Donohue
President
Coalition Against Regressive Taxation

COALITION AGAINST REGRESSIVE TAXATION
(partial list)

Air Transport Association
American Petroleum Institute
American Pulpwood Association
American Trucking Associations
Beer Institute
Brown & Williamson Tobacco
Cigar Association of America
Distilled Spirits Council of the U.S.
Joseph E. Seagram & Sons
National Association of Tobacco Distributors
National Automobile Dealers of America
National Beer Wholesalers Association
National Candy Wholesalers Association
Petroleum Marketers Association of America
Phillip Morris Companies, Inc.
R.J.R. Nabisco, Inc.
Rubber Manufacturers of America
Smokeless Tobacco Council
Tobacco Institute
Truck Trailer Manufacturers Association
Wine and Spirits Wholesalers of America

AN ANALYSIS OF THE REGRESSIVITY OF EXCISE TAXES

Submitted to the
Coalition Against Regressive Taxation

by

The Policy Economics Group
of
Peat Marwick Main & Co.

May 1987

EXECUTIVE SUMMARY

This report presents the results of a detailed analysis of the distributional impact of excise taxes on gasoline, alcohol beverages and tobacco in comparison to the Federal personal income tax and the social security payroll tax. The analysis of alcohol beverage taxes is disaggregated between beer, wine, and distilled spirits.

The analysis was made using recent data from a wide variety of sources. These data were incorporated into the analysis using sophisticated statistical techniques and the Policy Economics' Federal tax model and data base.

All the excise taxes examined in this report were found to be regressive. The social security payroll tax was also found to be regressive, though less so than any of the excise taxes, and the individual income tax was found to be progressive.

The analysis disaggregates the effects of the taxes examined between the aged and non-aged population. The results show that the average excise tax rate is greater for the aged than for the non-aged. The reverse is the case for income and payroll taxes.

The report presents the potential distributional effects of excise tax increases currently being considered by the Congress in its deliberations on the 1988 budget. An excise tax increase of as much as $18 billion is currently being considered in these deliberations. The report shows that an excise tax increase of this magnitude would raise the taxes of low income taxpayers disproportionately and would substantially more than offset the income tax reduction these taxpayers received from the Tax Reform Act of 1986.

This is highlighted in the table below, which compares the distributional effect of an $18 billion increase in excise taxes to the reduction in income taxes enacted in the Tax Reform Act of 1986. It shows that, for families with incomes of less than $10,000, the excise tax increase is nearly 5 times as great as the income tax reduction.

Comparison of Enacted Income Tax Reductions and Potential Excise Tax Increases

Income Class ($000's)	Income Tax Reduction	Excise Tax Increase	Net Tax Change	Excise Tax Increase as a percent of income tax reduction
	(------------$ Millions	------------	------------)	
< 10	-$414	$1,981	+$1,568	479%
10 - 20	-2,983	2,653	-329	89
subtotal	**-3,397**	**4,635**	**+ 1,238**	**136**
20 - 30	-3,319	2,836	-483	85
30 - 50	-8,112	5,366	- 2,746	66
50 - 100	-7,609	4,324	- 3,284	57
subtotal	**-19,040**	**12,526**	**-6,513**	**66**
100 - 200	-3,572	610	-2,963	17
200 >	-9,689	229	-9,460	2
subtotal	**-13,261**	**839**	**-12,423**	**6**
Total	**$-35,698**	**$18,000**	**$-17,698**	**50%**

INTRODUCTION

This report presents an analysis of the distributional effects of the Federal personal income tax, the social security payroll tax, the gasoline excise tax, the tobacco excise tax, and alcohol excise taxes. The analysis of alcohol tax burdens is disaggregated between taxes on distilled spirits, wine, and beer.

The report is organized into four sections. The first section discusses alternative approaches to measuring excise tax burdens and summarizes briefly the results of two studies on this subject. The second section analyzes the method used for measuring the distributional effects of the different taxes. It describes the expanded income concept used in the calculation and the Gini coefficient and Lorenz curves used in the analysis. The third section describes the sources of data used in the analysis and the statistical methods employed to transform these data to meet the needs of this study. The final section presents the results of the analysis.

The report includes an appendix that presents the data used in developing the statistical analysis and the sources of these data.

I. EXCISE TAX BURDENS: BACKGROUND

There are essentially two alternative approaches to evaluating the distributional impact of taxes. One approach, which is used in this study, is to analyze the tax burden, or effective tax rate, by income level for the tax or taxes being analyzed. Summary measures of the distributional impact can then be calculated from these effective tax rates by income class. This is the best approach for analyzing tax burden impacts, because the tax burden can be measured and assessed at a number of specific income levels. This approach is the most difficult to undertake, however, because it requires specific data on tax burdens at different income levels, and these data are not always readily available.

An alternative approach is to estimate the relationship between tax collections and income and make summary judgments about the distributional impact of the tax from this relationship. If the responsiveness of tax revenues to income, i.e., the income elasticity, is greater than one, tax burdens can generally be expected to be higher at high income levels than at lower income levels. If the income elasticity is less than one, the reverse is the case. Studies that estimate the distributional impact in this way have the advantage of not requiring data on tax burdens by income class. Time series or cross-section data can be used to make these assessments. The disadvantage is that the distributional impact is measured in a single number; no data are available by specific income classes.

Measurement of Tax Burdens by Income Class

One of the major principles for measuring the equity of a tax is the "ability to pay" principle, which requires equal taxation of people with equal ability and, for people with unequal ability, increases in taxation as ability to pay increases. One of the fundamental ways to measure the burden of a tax relative to the ability to pay is to calculate the dollar tax payment as a percent of household income. The tax is said to be progressive, regressive, or proportional if the tax, as a percent of household income, rises, falls or remains constant as household income rises. For example, consider the following table displaying hypothetical income and tax data.

Table 1

Tax Burden Under Three Hypothetical Taxes

	Income			
	$10,000	$25,000	$50,000	$100,000
Tax 1:				
Dollars	$1,000	$2,500	$5,000	$10,000
Percent of Income	10%	10%	10%	10%
Tax 2:				
Dollars	$1,000	$3,000	$7,500	$18,000
Percent of Income	10%	12%	15%	18%
Tax 3:				
Dollars	$1,000	$2,000	$3,000	$4,000
Percent of Income	10%	8%	6%	4%

Clearly, tax 1 is proportional, tax 2 is progressive, and tax 3 is regressive. (Note that in all cases, however, higher income persons pay more tax under each of these three hypothetical taxes.)

One major study that analyzes the distributional impact of excise taxes using data on tax payments by income classes was done by Donald Phares in 1980. His study, which analyzed the distributional impact of all major state and local taxes, used data from the Bureau of Labor Statistics 1978 Consumer Expenditure Survey as the basis for assessing the distributional impact of consumption-based taxes. His results, reported in Table 2, show that the effective tax rate on excise taxes declines sharply as income rises.

Table 2

Effective Tax Rates Of Selected Consumption Based Taxes As Estimated By Donald Phares[1]

(tax as a percent of income)

Income Class	Tobacco Tax	Alcohol Tax	Motor Fuels Tax	General Sales Tax
Under $3,000	1.18	0.34	2.25	5.02
3,000 to 3,999	0.67	0.25	1.40	3.49
4,000 to 4,999	0.55	0.23	1.20	3.12
5,000 to 5,999	0.48	0.21	1.06	2.87
6,000 to 6,999	0.43	0.21	0.99	2.75
7,000 to 7,999	0.39	0.20	0.92	2.64
8,000 to 9,999	0.34	0.19	0.83	2.47
10,000 to 11,999	0.30	0.19	0.75	2.34
12,000 to 14,999	0.27	0.18	0.68	2.20
15,000 to 19,999	0.23	0.17	0.61	2.06
20,000 to 24,999	0.20	0.17	0.57	1.97
25,000 to 29,999	0.18	0.17	0.53	1.91
30,000 to 35,000	0.17	0.16	0.51	1.83
Above $35,000	0.14	0.15	0.45	1.63

Note: The effective tax rates shown above reflect the average state and local tax rates as a percentage of income based on 1978 data.

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[1] Phares, Donald, Who Pays State and Local Taxes?, Cambridge, Mass.: Oelgeschlager, Gunn (1980).

A second and more recent study, prepared by the U.S. Congressional Budget Office, examined the distributional effects of major federal excise taxes. The distributional effects were measured relative to a broad-based definition of family income similar to that used in this study, and to total family expenditures. The distributional estimates were based on the income and expenditure data in the 1982-83 Consumer Expenditure Survey (CES). The estimates measured relative to family income are presented in Table 3 and again show that excise tax rates decline sharply as incomes rise.

Table 3

Effective Tax Rates For Expenditures
Subject to Federal Excise Tax: 1985
As Estimated by the Congressional Budget Office [1/]

Income Class	Tobacco Tax	Alcohol Taxes			Gasoline Tax	Telephone Tax	Airfare Excise Tax
		Beer	Wine	Liquor			
Under 5,000	1.05	0.37	0.07	0.75	1.62	0.61	0.43
5,000 - 9,999	0.44	0.12	0.02	0.24	0.58	0.21	0.14
10,000 - 19,999	0.29	0.10	0.02	0.20	0.50	0.14	0.12
20,000 - 29,999	0.21	0.07	0.02	0.16	0.41	0.11	0.10
30,000 - 39,999	0.17	0.07	0.01	0.14	0.35	0.09	0.08
40,000 - 49,999	0.13	0.05	0.01	0.12	0.31	0.08	0.09
50,000 or More	0.07	0.04	0.01	0.11	0.22	0.07	0.09
Total	**0.17**	**0.06**	**0.01**	**0.15**	**0.35**	**0.10**	**0.10**

[1/] U.S. Congressional Budget Office, "The Distributional Effects of an Increase in Selected Federal Excise Taxes," Staff Working Paper, January 1987.

II. METHOD OF ANALYZING DISTRIBUTIONAL IMPACT

In assessing the distributional impact of taxes, two important conceptual issues and one important analytic issue arise. The conceptual issues relate to 1) the incidence of taxes and 2) the measure of income used. The analytic issue relates to the method used to summarize the distributional data and establish a framework that permits comparisons between different taxes.

Incidence of Taxes

The incidence of taxes is critical to any distributional analysis. The distributional impact of a payroll tax, for example, will differ depending upon whether the tax is passed forward to consumers through higher product prices, is borne by wage earners, or is passed back to employers.

A detailed discussion of tax incidence is beyond the scope of this paper, but it is important to state explicitly the incidence assumptions that have been made. It is assumed that the personal income tax is borne by the income earner; the payroll tax is borne by the wage earner; and consumption taxes are borne by the consumer. These are conventional assumptions that are generally consistent with previous economic research.

Income Measure

The estimated distributional impact of taxes can vary by the income definition used in the analysis. The major conceptual issue in the literature is whether "permanent" or current income should be used. Permanent income was first discussed by Milton Friedman when he separated income into a permanent and a transitory component.[1/] Friedman argued that changes in transitory income would have less effect on consumption (and, therefore, consumption-based taxes) than permanent income.

This issue is potentially important to analyses of the distributional impact of consumption-based taxes. If individuals have low current incomes because of temporary factors, such as unemployment, their consumption may not be affected to the same degree as their income change. The same applies to individuals who have unusually high current incomes due to temporary factors, such as irregular bonuses. The use of current income, therefore, can overstate the degree of regressivity of consumption-based taxes.

One major problem with the permanent income hypothesis for empirical studies is that it is not directly measurable, and proxy measures such as the average income level over some period of years, require more data than are generally available. A second argument that has been made against using permanent income is that "...taxes must be paid when they come due, and the more that has to be paid at any one time, the less is left for private use at that time."[2/] For these reasons, most empirical studies of tax burdens use some measure of current income as the basis for the analysis.[3/]

[1/] Milton Friedman, A Theory of the Consumption Function, Princeton, N.J.: Princeton University Press, 1957.

[2/] Richard A. and Peggy B. Musgrave, Public Finance in Theory and Practice, 2nd ed., New York: McGraw-Hill, 1976, p. 443.

[3/] The previously cited Congressional Budget Office study used consumption (as a proxy for permanent income) as one of two measures of ability to pay.

The current income concept used in this report is a broad-based measure of income. This measure includes income sources that are not currently included in the income tax base, such as transfer payments, certain fringe benefits (including employer contributions for social security), and interest from tax-exempt State and local bonds.

Summary Measures of Distributional Impact

If one wishes to compare the burdens of two or more taxes, it is useful to derive an index of tax burden that can be applied across taxes. Such indexes can be found in the literature on income distribution. Lorenz curves and Gini coefficients, common measures of income distribution, are modified in the present report to measure the burden of several U.S. taxes.

The Lorenz curve was originally designed to measure the income distribution of an economy by plotting the accumulated percent of total family income on the vertical axis and the accumulated percent of families on the horizontal axis (see Figure 1). An equal distribution of income is represented by the 45 degree line OR. The Lorenz curve OSR represents an unequal distribution because 50 percent of the families have less than 50 percent of total family income. The further OSR bows away from OR, the greater is the inequality of income distribution.

To measure the degree of this inequality, the Gini coefficient takes the ratio of the area between OR and OSR to the area of triangle OPR. The greater the inequality, the greater is the area between OR and OSR, and the closer the Gini coefficient is to unity. Thus, the Gini coefficient ranges from 0, where there is exact equality in the distribution of income, to 1, where all income is concentrated in one family.

The Lorenz curve and Gini coefficient concepts can be modified to analyze tax burden distributions. In Figure 2, the accumulated percent of household income is plotted on the

Figure 1

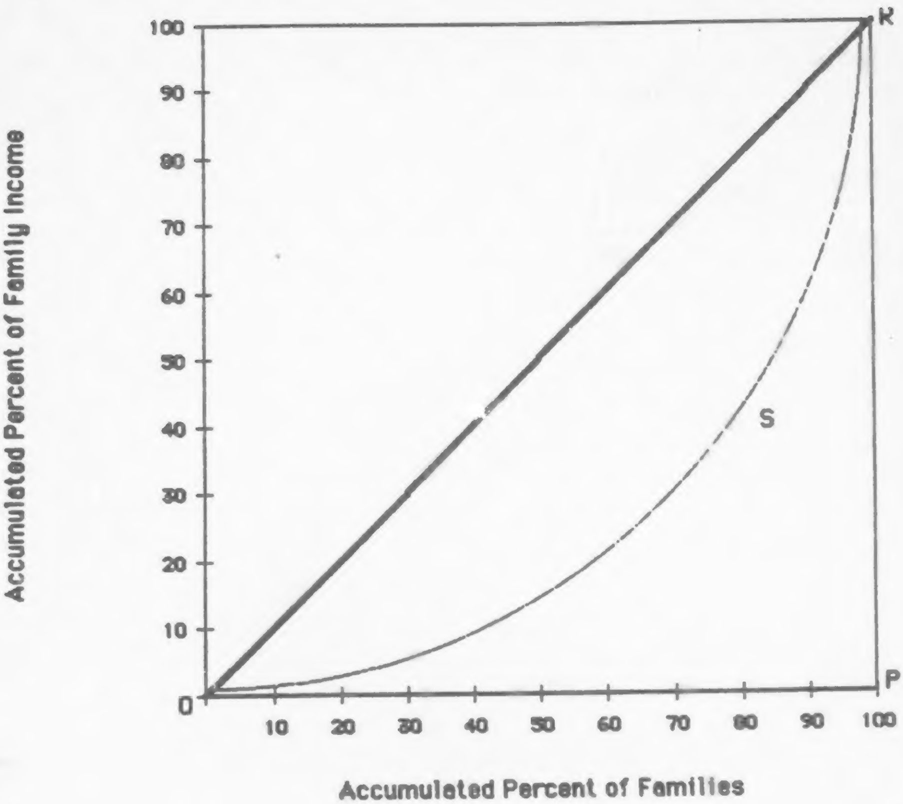
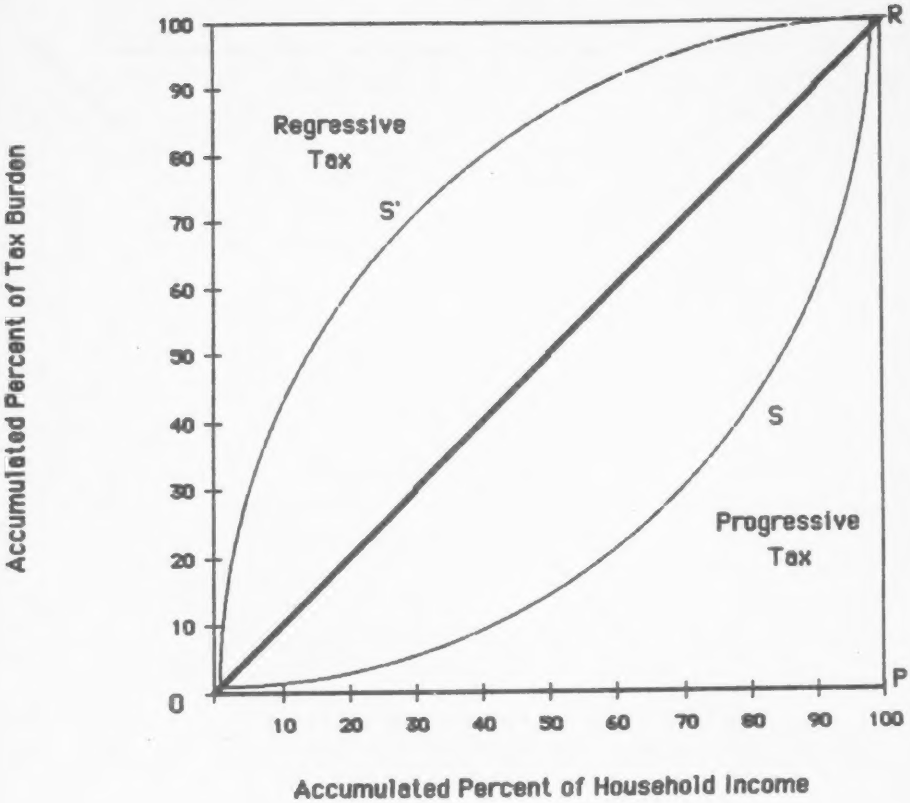

R
S
P
0
10
20
30
40
50
60
70
80
90
100
Accumulated Percent of Family Income
Accumulated Percent of Families

Figure 2


100
90
80
70
60
50
40
30
20
10
0
10
20
30
40
50
60
70
80
90
100
R
P
Regressive Tax
S'
S
Progressive Tax
Accumulated Percent of Tax Burden
Accumulated Percent of Household Income

horizontal axis and the accumulated percent of tax burden on the vertical axis. Following the procedure of Daniel B. Suits[3/], if the area of triangle OPR is designated as K and the area under the Lorenz curve as B, then the income tax burden (I) is defined as:

$$\begin{aligned} I &= (K-B)/K, \\ &= 1-(B/K) \end{aligned}$$

The Lorenz curve OSR represents a progressive tax because the poorest 50 percent of the households pay less than 50 percent of the tax while the wealthiest 50 percent pay more than 50 percent of the tax. In this case, area B is less than area K and $I > 0$. Lorenz curve OS'R represents a regressive tax because the poorest 50 percent of the household pays more than 50 percent of the tax while the wealthiest 50 percent pay less than 50 percent of the tax burden. Area B is greater than area K and $I < 0$. Line OR represents a tax whose burden is equally distributed among the households. Therefore, I can range from -1 to +1. The closer I is to -1, the greater is the tax regressivity and the burden on low income classes; the closer I is to +1, the greater is the tax progressivity and the burden on high income classes. If $I = 0$, the tax is proportional and the burden is equally distributed among income classes.

3/ Suits, Daniel B., "Measurement of Tax Progressivity," American Economic Review, 67 (September 1977), pp 747-752.

III. SOURCES OF DATA

This section presents the data used in the analysis of the distribution of tax burdens. The first part of this section shows the control totals for receipts in 1986 for each of the major revenue sources analyzed in this report. The second part discusses the sources of data for allocating these tax burdens by income class.

Control Totals

Table 4 shows the aggregate levels of receipts in 1986 for the revenue sources discussed in this report. The footnotes to that table show the sources of these data. For individual income taxes, and social security payroll taxes, only the Federal tax is analyzed in this report. For the other taxes, Federal and state taxes are considered in the distributional analysis. The state taxes are included as national weighted averages and are, therefore, distributed the same as their Federal counterpart; their inclusion, therefore, affects the *level* of affected tax rates but it does not affect the *distribution* of tax rates among income classes.

Data on Distribution of Tax Burdens

The sources of data on the distribution of tax burdens by income class come from several sources, as described below.

Federal individual income taxes and social security payroll taxes are calculated using the Policy Economic Group's federal tax model and data base. This data base includes a sample of approximately 300,000 observations, 50 percent greater than the sample size used by the U.S. Treasury Department for analyzing Federal income tax issues--and the computer model contains more than 10,000 lines of computer coding to calculate Federal income and FICA tax liabilities.

Table 4

1986 Tax Revenues
(millions of dollars)

	Federal	State	Total
Federal individual income tax[1]			
Prior Law	352,583	na[2]	na[2]
Tax Reform Act of 1986	316,885	na[2]	na[2]
Social security payroll tax[3] (employee share)	123,500	na	na
Excise Taxes:			
Gasoline excise tax[4]	9,327	15,260	24,587
Tobacco excise tax[5]	4,468	4,622	9,090
Alcohol excise tax[6]			
Beer	1,499	1,032	2,531
Wine	415	288	703
Distilled spirits	3,688	1,456	5,144
Total Excise Taxes	19,397	22,658	42,055

Sources:

1/ Policy Economics Group federal income tax model. Data are for calendar year 1986. Data for the Tax Reform Act are for fully phased-in tax law.

2/ State income taxes were not included in this analysis. State income tax structures vary significantly from state to state and their aggregate distribution is likely to vary significantly from the Federal income tax. For this reason, it would be misleading to assume that state income taxes have the same distributional effects as the Federal income tax.

3/ Social Security Administration, unpublished data. Data are for calendar year 1986.

4/ Bureau of Economic Analysis, U.S. Department of Commerce, unpublished data. Data are for calendar year 1986.

5/ Tobacco Institute, The Tax Burden on Tobacco, 1986. Data are for fiscal year 1986 ending June 30, 1986.

6/ Federal data are from the Distilled Spirits Council of the United States and are unpublished. The statistics are for fiscal year 1986 ending September 30, 1986. The state data were estimated by the Policy Economics Group based on historical trends. These data are also for fiscal year 1986.

Gasoline excise taxes are estimated based on data from the Bureau of Labor Statistics 1983 Consumer Expenditure Survey, which shows the distribution of gasoline and oil expenditures by income class. On the basis of these Survey data, gasoline consumption was imputed to each taxpayer in the Policy Economic Group's data base.

Data on alcohol beverage consumption are from Simmons Market Research Bureau, which conducted a survey of approximately 20,000 individuals in 1985. This survey recorded information on the economic and demographic characteristics of the drinking population, and on the level of consumption for each category of drinker. Appendix Table A-1 summarizes the Simmons data.

On the basis of these data, a statistical imputation was made to the Policy Economic Group's Federal data file to "identify" drinkers and non-drinkers, consistent with the percentages in Appendix Table A-1. For the drinking population that resulted from this statistical procedure, the volume of consumption was then imputed in a similar manner consistent with the data in the same table.

Data on tobacco consumption are taken from two sources and are summarized in Appendix Table A-2. Data on the percentage of males and females age 20 and above who smoke, and the amounts that they smoke, are derived from the U.S. Department of Health and Human Services 1986 National Health Interview Survey, which sampled 100,000 adults age 20 and above. Data for persons under age 20 were derived from a 1985 household survey conducted by the Alcohol, Drug Abuse, and Mental Health Administration.

On the basis of these data, a statistical imputation identical to that described for drinkers was made to the Policy Economic Group's microsimulation data base to identify smokers and the amounts that they smoked.

The discussion above relates to the measurement of tax burdens on individuals from their personal consumption of the taxed products. Some excise taxes are in fact paid by businesses from their purchases of taxed products. Excise taxes paid by business were distributed to all consumers in proportion to their consumption of total goods and services. Specifically, 20 percent of gasoline and alcohol taxes were distributed in this manner.

IV. PRESENTATION OF RESULTS

This section presents the empirical results from the detailed statistical analysis performed by Policy Economics. The first part compares the distributional impact of each of the excise taxes analyzed in this report to income and payroll taxes. It shows that the excise taxes are highly regressive. The second part presents estimates of the tax burden for the aged and non-aged. It shows that, in the aggregate, excise tax burdens are greater for the aged population than the non-aged population.

Distribution of Excise Taxes Relative to Other Taxes

Tables 5 and 6 show the distribution of the tax burden in 1986 among seven different income classes for each of the taxes analyzed in this report. Table 5 shows the tax burden for each income class as a percentage of income within that income class. These percentages represent effective tax rates for each tax by income class. This table permits an assessment of both the distributional impact of the tax and the relative size of the different taxes by income class.

Table 6 shows the percentage of the total tax burden for each tax that is absorbed by each of the seven income classes and for sub-aggregates of these income classes. This table provides a useful comparison of the relative progressivity or regressivity of the different taxes. It also shows the Gini coefficients for each of the different taxes. As noted earlier, a positive value for the Gini coefficient indicates that the tax is progressive and a negative value indicates it is regressive.

Table 5

Effective Tax Rates: Tax Burden as a Percent of Income by Income Class

Income Class ($000's)	Federal Individual Income Tax		Social Security Payroll Tax	Tobacco Excise Tax	Gasoline Excise Tax	Alcohol Excise Taxes			Total Excise Taxes
	Prior Law	Tax Reform Act of 1986				Beer	Wine	Distilled Spirits	
< 10	1.154	0.693	2.236	1.285	2.724	0.370	0.082	0.624	5.085
10-20	3.927	2.773	3.294	0.565	1.263	0.156	0.040	0.326	2.350
20-30	6.855	6.023	3.906	0.396	0.927	0.105	0.026	0.198	1.652
30-50	9.181	8.356	4.346	0.276	0.768	0.070	0.021	0.149	1.284
50-100	11.405	10.706	4.258	0.169	0.587	0.052	0.016	0.114	0.938
100-200	16.820	15.380	2.623	0.103	0.358	0.035	0.010	0.072	0.578
>200	23.748	19.771	0.736	0.035	0.144	0.013	0.004	0.027	0.223
AVERAGE	10.649	9.571	3.730	0.275	0.743	0.077	0.021	0.155	1.271

Table 6

Distribution of Tax Burden by Income Class

(Percent)

Income Class ($1,000's)	Percent of Economic Income in Each Income Class	Federal Individual Income Tax		Social Security Payroll Tax	Tobacco Excise Tax	Gasoline Excise Tax	Alcohol Excise Taxes			Total Excise Tax
		Prior Law	Tax Reform Act of 1986				Beer	Wine	Distilled Spirits	
0-10	2.7	0.3	0.2	1.6	12.7	9.9	13.1	10.4	10.9	10.8
10-20	7.8	2.9	2.3	6.9	16.1	13.3	15.9	14.6	16.4	14.4
Subtotal, Low to Moderate Income	**10.5**	**3.2**	**2.5**	**8.5**	**28.8**	**23.2**	**29.0**	**25.0**	**27.3**	**25.3**
20-30	12.1	7.8	7.6	12.6	17.4	15.1	16.5	14.9	15.3	15.7
30-50	29.7	25.6	25.9	34.6	29.9	30.7	27.3	29.8	28.5	30.0
50-100	32.9	35.2	36.8	37.6	20.2	26.0	22.5	25.2	24.1	24.3
Subtotal, Middle and Upper Middle Income	**74.6**	**68.6**	**70.3**	**84.8**	**67.5**	**71.7**	**66.3**	**70.0**	**68.0**	**70.0**
100-200	7.5	11.8	12.0	5.3	2.8	3.6	3.4	3.7	3.5	3.4
>200	7.4	16.4	15.2	1.5	0.9	1.4	1.3	1.4	1.3	1.3
Subtotal, High Income	**14.9**	**28.2**	**27.2**	**6.7**	**3.8**	**5.0**	**4.7**	**5.0**	**4.8**	**4.7**
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Gini Coefficient	**N.A**	**+0.23**	**+0.23**	**-0.05**	**-0.35**	**-0.25**	**-0.32**	**-0.27**	**-0.29**	**-0.28**

All of the results are within the range of a priori expectations. The Federal individual income tax is shown to be the only progressive tax of those analyzed, with all other taxes being regressive. Of the regressive taxes, the excise taxes on tobacco and beer are the most regressive. The distributional results for each of the taxes are described briefly below.

Federal individual income taxes.--The Federal individual income tax is widely recognized to be a highly progressive tax. This progressivity results from both the progressive rate structure and from the personal exemptions and zero bracket amounts that are a part of this tax structure. The average Federal income tax rate in 1986 was 10.6 percent, as shown in Table 5. Under the provisions of the Tax Reform Act of 1986, when fully phased in, this tax rate will drop to 9.6 percent.

As Table 5 shows, the average effective income tax rate was substantially higher for high income taxpayers than for low income taxpayers. For taxpayers with incomes between $10,000 and $20,000, for example, the rate averaged 3.9 percent of income, whereas for taxpayers with incomes above $200,000 this rate averaged 23.7 percent of income. Table 8 shows that 28 percent of these taxes were paid by high income taxpayers, a substantially higher percentage than for any other tax. Consistent with this distributional impact, the Gini coefficient is estimated to be +0.23 under both prior law and the Tax Reform Act. These are the only estimated Gini coefficients with a positive sign.

Social security payroll taxes (employee share).-- Social security taxes are shown to be regressive at the high income levels. This result reflects the fact that the social security payroll tax is a single rate applicable to wages up to a statutory maximum ($42,000 in 1986), with no tax imposed on wages above that level. The measured regressivity also reflects the fact that the average wage share of income diminishes as incomes rise.

The average social security tax rate in 1986 was approximately 3.7 percent of income. As noted above, this rate reflects only the employee share of this tax. If the employer share were included on the assumption that employees bear this portion of the tax as well (as conventional economic wisdom suggests) this rate would be twice as large. The distribution of the tax burden across income classes would, however, be the same.

As shown in Table 6, only 6.7 percent of social security payroll taxes are borne by households with incomes above $100,000, roughly one-fourth the comparable percentage for income taxes. Similarly, 8.5 percent of social security taxes are borne by low to moderate income households, about three times the comparable percentage for income taxes.

Tobacco excise taxes.-- Tobacco excise taxes are estimated to average 0.275 percent of total income of all taxpayers. The average tax rate in the low income classes is substantially higher than the average; for the high income classes, the reverse is the case. In the lowest income class, for example, the tax averages 1.3 percent of income whereas in the top income class it is only 0.035 percent of income. Table 6 shows that 28.8 percent of tobacco excise taxes are paid by low to moderate income earners, a higher percentage than for any other tax except beer, which is 29.0 percent. The Gini coefficient is -0.35 for tobacco taxes, the lowest of all the tax sources analyzed, highlighting the degree to which the tax is regressive.

Gasoline excise taxes.-- The gasoline excise tax is also shown to be highly regressive. This conclusion reflects the fact that gasoline consumption is a much higher percentage of low income family budgets than of high income family budgets. The average tax rate, including both Federal and state excise taxes, is 0.74 percent. For households with incomes below $30,000, the rate is higher than average; for household incomes above $50,000 it is lower. As Table 6 shows, almost one fourth of the gasoline tax is borne by low to moderate income households and only 5 percent is borne by high income households. This regressivity is reflected in the Gini coefficient, which is -0.25.

Alcohol excise taxes.-- The distributional impact of alcohol taxes varies between beer, wine, and distilled spirits and were therefore analyzed separately in this report. All three taxes are estimated to be regressive. The gini coefficient for beer is -0.32; for wine it is -0.27; and for distilled spirits it is -0.29.

Tax Burden for the Aged and Non-Aged Population

As Table 7 highlights, excise tax burdens for the aged are somewhat higher than for the non-aged population. In the aggregate, the effective excise tax rate for the excise taxes examined in this report is 1.39 percent for the aged and 1.26 percent for the non-aged.

This result contrasts sharply with the results for the individual income tax and the social security payroll tax, which show the average effective tax rate sharply lower for the aged population.

Table 7

Effective Tax Rates of Aged and Non-Aged Population

(Percent)

	Under Age 65	Age 65 And Over	Difference
Individual Income Tax:			
Prior law	11.19	8.34	-2.85
Tax Reform Act	10.03	7.65	-2.38
Social Security Payroll Tax	4.21	1.30	-2.91
Excise Tax	1.26	1.39	+0.13

Potential Effect of Budget Resolution Revenue Increases

Both the House and the Senate have passed versions of the 1988 concurrent budget resolution that call for substantial tax increases in 1988 and subsequent years. The House version of the resolution would require tax increases of $18.0 billion in 1988. The Senate version is closely aligned with the House, recommending a tax increase of $18.3 billion in 1988 and $118 billion over the next four years.

The resolution figures cited above represent general targets for the tax writing committees. The specific tax policy changes required to achieve those targets are to be determined subsequently by the tax writing committees themselves and are therefore uncertain at this time.

Nevertheless, it does appear likely that excise taxes could be identified as a major potential source for tax increases. The Senate has already passed an accompanying "sense-of-the-Senate" resolution stating that the required tax increases were not to result from an increase in individual and corporate tax rates. Furthermore, Senate Finance Committee Chairman Bentsen has explicitly identified excise taxes, together with user fees and loophole closing measures, as initial targets for meeting the resolution revenue figures.

The federal excise taxes analyzed in this report--gasoline, tobacco, and alcohol--comprise more than three-fifths of total federal excise taxes. If excise taxes play a prominent role in achieving the resolution revenue target, the burden of these tax increases will be borne disproportionately by low income taxpayers, as the analysis in the previous section demonstrated.

Table 8 highlights this point by showing the potential effect of an $18 billion excise tax increase relative to the individual income tax reductions enacted in the Tax Reform Act of 1986. The estimates assume that the excise tax increases are distributed in proportion to the amount of federal revenues raised by gasoline, alcohol and tobacco excise taxes.

Table 8

Comparison of Enacted Income Tax Reductions and Potential Excise Tax Increases

Income Class ($000's)	Income Tax Reduction	Excise Tax Increase	Net Tax Change	Excise Tax Increase as a percent of income tax reduction
	(------------	$ Millions	-----------)	
< 10	-$414	$1,981	+$1,568	479%
10 - 20	-2,983	2,653	-329	89
subtotal	**-3,397**	**4,635**	**+1,238**	**136**
20 - 30	-3,319	2,836	-483	85
30 - 50	-8,112	5,366	-2,746	66
50 - 100	-7,609	4,324	-3,284	57
subtotal	**-19,040**	**12,526**	**-6,513**	**66**
100 - 200	-3,572	610	-2,963	17
200 >	-9,689	229	-9,460	2
subtotal	**-13,261**	**839**	**-12,423**	**6**
Total	**$-35,698**	**$18,000**	**$-17,698**	**50%**

Note: Detail may not add to total due to rounding.

Under this tax policy option, the excise tax increase for low income taxpayers greatly exceeds the tax reduction these same taxpayers recived from the Tax Reform Act of 1986. For families with incomes of less than $10,000, the excise tax increase is nearly 5 times as great as the income tax reduction. In direct contrast, for taxpayers with incomes in excess of $100,000, the excise tax increase is only 6 percent of the enacted income tax reduction.

This illustrative example assumes that the full $18 billion revenue target is achieved through excise tax increases. It therefore represents one extreme on the continuum of tax policy options that the Congress could consider. The results show, nevertheless, that excise tax burdens fall disproportionately on low income families and that any significant increase in excise taxes would more than offset any income tax reductions received by these families.

Table 9 presents estimates of the distributional effects of a $1 billion increase in excise taxes for each of the excise taxes examined in this report. This table provides a foundation for assessing the distributional effects of alternative excise tax policies.

Table 9

Distributional Impact of a $1 Billion Increase in Each Major Excise Tax

($ Millions)

Income Class ($000's)	Tobacco Excise Tax	Gasoline Excise Tax	Alcohol Excise Taxes		
			Beer	Wine	Distilled Spirits
< 10	127	99	131	104	109
10-20	161	133	159	146	164
Subtotal, Low to Moderate Income	**288**	**232**	**290**	**250**	**273**
20-30	174	151	165	149	153
30-50	299	307	273	298	285
50-100	202	260	225	252	241
Subtotal, Middle and Upper Middle Income	**675**	**717**	**663**	**700**	**680**
100-200	28	36	34	37	35
> 200	9	14	13	14	13
Subtotal, High Income	**38**	**50**	**47**	**50**	**48**
Total	1000	1000	1000	1000	1000

Appendix Table A-1

Income And Demographic Characteristics Of The Drinking Population

Classification	Percent of Population That Regularly Consumes Alcohol Beverages			Number of Drinks Consumed in an Average Seven Days 1/		
	Beer	Wine	Distilled Spirits	Beer	Wine	Distilled Spirits
Age						
18 - 24	56.7	47.2	52.9	166,994	36,093	46,275
25 - 34	56.9	51.6	58.8	197,271	54,793	63,543
35 - 44	51.4	49.5	57.6	113,431	44,651	48,806
45 - 54	47.3	46.1	52.5	84,479	35,129	37,749
55 - 64	40.7	41.9	47.0	68,778	31,133	36,853
> 64	30.6	32.2	33.8	60,070	28,967	30,785
Household Income ($000's)						
< 10	40.0	30.1	36.2	114,763	26,210	31,877
10 - 15	43.0	34.6	42.3	95,368	22,418	31,708
15 - 20	48.1	40.3	49.7	63,465	16,397	23,445
20 - 25	50.5	43.4	49.8	79,990	22,913	26,359
> 25	52.6	55.4	59.9	337,436	142,828	150,621
Sex						
Male	68.9	41.7	52.5	459,511	124,998	149,952
Female	29.1	49.0	50.2	231,512	105,768	114,059

1/ The average amounts consumed in one glass of beer, wine, and distilled spirits are twelve, five, and one and a quarter ounces respectively.

Appendix Table A-2

Income and Demographic Characteristics Of The Smoking Population

(Percent)

Classification	Percentage of Population Group That Smokes	Cigarettes Smoked Per Day: Less Than 15	Cigarettes Smoked Per Day: 15-24	Cigarettes Smoked Per Day: Greater Than 24
Male: Age				
Under 20	14.9	48.2	38.9	12.9
20-24	31.0	34.9	48.0	17.1
25-34	38.2	28.9	42.6	28.5
35-44	37.6	20.1	37.6	42.3
45-64	33.4	21.2	39.5	39.3
> 64	19.6	33.6	41.0	25.4
Female: Age				
Under 20	13.6	48.2	38.9	12.9
20-24	32.1	45.8	42.0	12.2
25-34	32.0	36.5	42.2	21.3
35-44	31.5	31.0	41.3	27.8
45-64	29.9	33.0	44.2	22.7
> 64	13.5	42.3	44.2	13.4
Household Income ($000's)				
< 7	31.1	33.4	42.9	23.7
7 - 15	33.4	30.8	53.3	15.9
15 - 25	32.2	29.9	47.7	22.4
25 - 35	30.0	21.6	46.5	32.0
35 - 50	25.2	23.7	44.4	31.9
> 50	25.2	23.7	44.4	31.9

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THE
COST
COALITION

CONSUMERS OPPOSED TO SECRET TAXES

1987 JUN 22 AM 11: 15

June 19, 1987

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Sam Simon, Former President
Telecommunications Research
and Action Center
WASHINGTON, DC

Dear Senator:

With higher excise taxes seemingly on everyone's list of deficit-fighting measures this year, I thought you might be interested in the enclosed excellent study. It demonstrates in stark terms what an increase in excise taxes will mean to consumers.

The study, which was conducted by the Washington economic consulting firm of Quick, Finan & Associates, was prepared for Consumers Opposed to Secret Taxes, of which I am chairman.

As the study points out, the average household will be paying an additional $284 every year – besides the $798 they already pay in federal, state and local excises – if Congress decides to collect $18 billion via excise taxes. That $284 is about three weeks worth of groceries for a family of four.

The study contains statistics for every state and several cities. In my own state of Massachusetts, where consumers pay $790 in federal and state excise taxes already, new excise taxes will cost them an extra $295, putting them up to $1,085 per year – a sizable burden for lower and middle income families.

It is the impact on those lower and middle income families that concerns me most. As you know, economists are in rare agreement on the fact that excise taxes are regressive, hitting hardest those least able to pay. I also object to the invisible nature of excise taxes in that consumers are generally unaware of what and how many products have excise taxes imposed on them. Following on the heels of tax reform - something which is suppose to ease the tax burden of lower and middle families - I see moves to boost excise taxes as a form of deceit and trickery.

As founding president of the Consumer Federation of America and professor of Economics at Boston College, I have always been concerned about consumer impact of governmental measures. I urge you to look carefully at the enclosed study and consider its serious ramifications for your constituents.

Respectfully,

Rev Robert McEwen

Rev. Robert J. McEwen, S. J.
Chairman, Consumers Opposed to
Secret Taxes

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THE
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CONSUMER LEADERS ANNOUNCE OPPOSITION TO EXCISE TAX HIKES

Study Details High Cost of Excise Taxes to Families

WASHINGTON, D.C., June 4, 1987 – Leaders from three national consumer organizations announced in a joint news conference today their opposition to Congressional proposals to increase excise taxes.

The news conference also marked the release of a study showing the effect of an excise tax hike on the average American family. In addition to the $790 that families pay each year for all excise taxes – federal, state and local – families will pay an additional $284 on average if Congress follows through on its proposal to raise $18 billion this year through excise taxes.

The study, which was conducted by Quick, Finan & Associates, a Washington, D.C. economic consulting firm, showed excise taxes rising by more than 75 percent with the Congressional proposal. Excise taxes are imposed on certain widely used products such as gasoline, beer and wine, cigarettes, telephone calls and airline tickets.

"An excise tax hike of this magnitude would be the largest in this country's history," said the study's principal author, Dr. Perry D. Quick. "It would cut in a major way into the income of many Americans."

Rev. Robert J. McEwen, S.J., Chairman of Consumers Opposed to Secret Taxes, or CO$T, a professor of economics at Boston College and a founding President of the Consumer Federation of America, praised the study. "This report

(more)

makes very clear that a rise in excise taxes will take money out of everyone's pocket," he said. "And the most heavily hit will be the lower and middle income families."

Father McEwen cited a report of the Congressional Budget Office which showed that an increase in excise taxes would be about twice as large, as a percentage of income, for families with earnings between $10,000 and $20,000 as it would be for families making $50,000 or more.

"How can our representatives even think of proposing an increase in excise taxes," said Father McEwen, "when excise taxes fall most heavily on the backs of those least able to pay."

The Quick, Finan economic study cited other potential negative effects from an excise tax, such as damage to retail sales and jobs, and distortions to prices and inflation measures. In addition, according to the study, "an increase in federal excise taxes would squeeze the states' revenue-raising capacity and could set off an upward spiral in state tax rates."

Father McEwen objected strongly to the fact that a rise in excise taxes would wipe out any gain that lower and middle income consumers received from last year's tax reform. "The fact is painfully obvious." he said. "If Congress raises excise taxes as they have said they want to do, the poor will lose twice what they gained by tax reform. They'll be further behind than ever."

Father McEwen was joined at the news conference by Jane King of The National Consumers League and Dan Mitchell of Citizens for a Sound Economy.

FEDERAL EXCISE TAXES:
COST TO AVERAGE AMERICAN HOUSEHOLD

Prepared for
The CO$T Coalition
by
Quick, Finan & Associates

June 1987

FEDERAL EXCISE TAXES: COST TO AVERAGE AMERICAN HOUSEHOLD

Some federal legislators are seeking to raise $18 billion in new revenues to meet the Gramm-Rudman federal budget target for the next fiscal year. One proposal to meet this net revenue target would impose additional federal excise taxes on gasoline, alcohol, tobacco products and telephone use amounting to over $26 billion in calendar year 1988, and more in later years. This increase in excise taxes--the steepest rise ever--would take about $285 from the average American household in calendar year 1988.

Proposal and Estimated Impacts

	Current Tax	Proposed Tax	Increase in Excise Tax For Average U.S. Household, 1988
Gasoline	9¢ per gallon	19¢ per gallon	$126
Cigarettes	16¢ a pack	32¢ a pack	43
Beer	16¢ per six pack	65¢ per six pack	51
Wine	3¢ per fifth	55¢ per fifth	23
Spirits	$2.50 per fifth	$3.00 per fifth	7
Telephone	0 (sunset)	3 percent	34
		TOTAL	$284

The gross increase in excise taxes is larger than the net revenue target because a part of the excise tax rise--about $70 for the average American household--would be offset by a reduction in income taxes. Thus, the net tax cost to the average household would be about $215. The partial income tax offset is no benefit to American households, however, since it would come about because the new excise tax reduces household and business incomes (by the magnitude of the gross excise tax increase), and not because of a cut in income tax rates.

These estimates, as well as estimated household costs for the 50 states and some selected urban areas--shown in accompanying tables--were prepared by Quick, Finan & Associates (QFA) of Washington, DC, on the basis of one variant of the tax proposals currently being discussed in Congress. The proposal, shown in the third column of the table above, was recently put forward by the Congressional Budget Office and reported in The New York Times.

Under the current federal tax law, the average American household already pays $370 annually (1986 dollars) for federal excise taxes on these and other products and services.[1] In addition, every state has excise taxes on some or all of these items, and others as well. Total federal, state and local excise taxes amounted to $790 per household, or 2 percent of average household personal income, in 1986.

Under the proposal outlined here[2], federal excise taxes would rise by more than 75 percent, with tax rates on different components rising as follows:

- On gasoline, would increase 111 percent.
- On cigarettes, would double.
- On beer, would increase 306 percent.
- On table wine, would rise 1733 percent.
- On distilled spirits, would increase 20 percent.
- On telephone service, would continue at 3 percent rather than expire as currently in the law.

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[1] Federal excise taxes are also imposed on a variety of other items, including air fares, wagering, firearms, and bows and arrows, (see Budget of the United States Government, FY 1988, Supplement, Table 13).

[2] A contending alternative proposal would substitute an oil import fee for the gasoline tax component. This alternative would impose a still larger burden on the average American households, with those in the Northeast and other oil-importing states bearing a disproportionate burden. (See The New York Times, Thursday, May 7, 1987.)

The impact on average household incomes is only one drawback of the proposed excise tax increases. Other problems include:

- Regressivity--According to the Congressional Budget Office, excise taxes in 1985 amounted to 4.9 percent of total income for the average household with incomes under $5,000, versus only 0.6 percent for households with incomes of $50,000 or more.

- Job Losses--Citizens for Tax Justice estimated that an excise tax increase, proposed last year, that was smaller than the current proposal would lead to net job losses of almost 12,000 workers.

- Inflation--In the short run, the proposed increase in excise taxes would push up overall prices by more than 1/2 percent, with consumer prices even harder hit; flow-through effects from escalator contracts and normal business mark-ups could result in additional price increases.[3]

Moreover, an increase in federal excise taxes would squeeze the states' revenue-raising capacity and could set off an upward spiral in state tax rates. That is, if the boost in federal excise taxes cuts purchases of those items the states also tax, then state revenues will fall. Many states, given the already severe fiscal pressures, would be forced to raise excise tax rates in order to maintain their revenues. Thus, the ultimate increase in excise tax rates is likely to be larger than those shown above.

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[3] See studies by the Congressional Budget Office, Citizens for Tax Justice, and Policy Economics Group cited in References and Data Sources at the end of this report. The effect on overall prices is estimated as the gross excise tax increase (assumed to be passed on to consumers) divided by total GNP in 1988, as projected by the Office of Management and Budget.

Table 1

EXCISE TAX INCREASES PER HOUSEHOLD
BY STATE, 1988

State	Gas	Cig.	Beer	Wine	Spirits	Tele.	Total
Alabama	$140	$42	$39	$12	$ 5	$26	$264
Alaska	155	51	64	35	11	45	360
Arizona	130	36	60	25	7	31	290
Arkansas	152	44	38	7	4	25	271
California	119	37	52	45	7	39	299
Colorado	122	42	53	26	8	34	285
Connecticut	113	41	44	32	9	45	283
Delaware	144	51	56	23	9	35	320
Dist. of Colum.	73	42	58	24	8	41	246
Florida	116	39	55	23	8	31	272
Georgia	154	45	45	15	7	32	297
Hawaii	95	32	71	29	7	40	274
Idaho	141	40	52	19	5	28	285
Illinois	110	46	54	23	7	36	276
Indiana	145	51	48	13	5	30	292
Iowa	146	41	52	7	4	30	281
Kansas	148	43	43	9	4	32	280
Kentucky	141	69	41	8	5	26	290
Louisiana	147	50	54	18	7	28	304
Maine	133	48	47	20	7	29	284
Maryland	123	44	52	24	8	39	290
Massachusetts	108	46	56	34	10	40	295
Michigan	122	48	51	20	7	33	281
Minnesota	138	40	50	17	7	34	287
Mississippi	145	46	46	7	6	24	274
Missouri	145	46	50	15	5	31	291
Montana	170	40	64	19	6	28	328
Nebraska	147	39	54	12	5	31	289
Nevada	139	44	67	45	7	33	335
New Hampshire	114	50	51	25	8	37	285
New Jersey	123	43	47	35	8	43	299
New Mexico	162	33	62	19	4	27	306
New York	75	43	44	31	7	39	239
North Carolina	138	57	42	15	6	28	285
North Dakota	177	41	53	10	7	29	318
Ohio	127	46	54	15	4	32	278
Oklahoma	161	46	37	9	5	28	288
Oregon	128	40	46	31	5	29	279
Pennsylvania	107	42	54	14	5	32	254
Rhode Island	101	49	53	33	7	34	277
South Carolina	147	48	50	15	7	27	295
South Dakota	170	39	47	10	6	28	299
Tennessee	153	45	42	9	5	27	281
Texas	154	43	65	17	5	33	317
Utah	148	29	35	9	4	30	254
Vermont	130	52	56	30	8	30	306
Virginia	133	49	48	23	7	36	295
Washington	118	33	44	33	6	32	266
West Virginia	118	42	43	8	3	24	239
Wisconsin	122	39	71	19	8	32	291
Wyoming	234	50	59	14	7	32	396
US Average	$126	$43	$51	$23	$ 7	$34	$284

Table 2

EXCISE TAX INCREASE PER HOUSEHOLD BY SELECTED URBAN AREA, 1988

Area	Gas	Cigarette	Beer, Wine & Spirits	Telephone	Total
Atlanta, GA	$174	$48	$113	$33	$367
Boston, MA	98	38	100	28	264
Chicago, IL	137	43	92	39	311
Cincinnati, OH	120	43	63	31	258
Cleveland, OH	130	46	88	33	297
Detroit, MI	177	57	97	44	375
Houston, TX	176	45	113	32	365
Knoxville, TN	153	43	60	29	285
Memphis, TN	156	43	62	29	290
Milwaukee, WI	114	44	106	25	288
Mpls-St. Paul, MN	147	55	101	30	334
New York, NY	97	43	80	50	269
Pittsburgh, PA	108	49	72	32	261
San Francisco, CA	152	39	123	44	359
Seattle, WA	120	45	92	34	290
St. Louis, MO	143	49	63	31	287

Methodology of the QFA Study

The estimates of the impacts on average households in each state and in selected metropolitan areas were prepared by Quick, Finan & Associates in five steps, in order to properly align the aggregate federal revenues for the fiscal year with available data on household income and consumption patterns that are available only for calendar years.

1. Aggregate revenue figures for fiscal 1988 (October 1987 to September 1988) were converted to estimates of the 1988 calendar year total, as shown below.

	Tax Rates		Aggregate Revenues	
	Current	Proposed	Net[4] Fiscal 88	Gross Calendar 88
Gasoline per gallon	9¢	19¢	$ 8.6 Bn	$11.6 Bn
Cigarettes per pack	16¢	32¢	2.9	4.0
Beer per six	16¢	65¢	5.1	4.7
Wine[5] per fifth	3¢	55¢		2.1
Spirits per fifth[6]	$2.50	$3.00	0.4	0.6
Telephone percent[7]	0	3%	1.3	3.1
Gross				26.1
Income Tax Loss				(6.5)
NET			$18.3Bn	$19.6Bn

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[4] Net of reductions in income taxes due to reduced incomes; income tax offset allocated to each item.

[5] Excludes sweet wines and sparkling wines.

[6] Pro rata by proof gallon.

[7] Currently scheduled to expire at the end of 1987.

2. Note that the fiscal year figures from CBO are net of the income tax offset. The reduction in income taxes would occur because the excise tax increase would reduce household and business incomes by an amount equal to the new excise tax. Following the convention of the Treasury and the Congressional Budget Office, the aggregate income tax offset is estimated as the gross increase in excise taxes multiplied by the average rate of employment and income taxes. Applying this formula to the net fiscal year figures, the gross calendar year figures, as well as the aggregate $6.5 billion income tax offset, are estimated. The aggregate income tax offset is then distributed to states and urban areas on the basis of their shares of total income and employment taxes paid. The average income tax offset per household, $71 for all U.S. households, would be:

States

AL	$ 40	KY	$ 39	OH	$ 76
AK	88	LA	49	OK	59
AZ	47	ME	39	OR	49
AR	34	MD	103	PA	71
CA	76	MA	87	RI	67
CO	78	MI	94	SC	38
CT	125	MN	93	SD	35
DE	120	MS	28	TN	52
DC	108	MO	81	TX	72
FL	52	MT	36	UT	56
GA	56	NE	63	VT	43
HI	57	NV	60	VA	56
ID	49	NH	59	WA	56
IL	90	NJ	100	WV	31
IN	66	NM	40	WI	57
IA	42	NY	102	WY	43
KS	58	NC	46		

SMSAs

Atlanta	$64	Memphis	$ 60
Boston	90	Milwaukee	77
Chicago	83	Mpls-St. Paul	86
Cincinnati	73	New York	101
Cleveland	89	Pittsburgh	82
Detroit	91	San Francisco	90
Houston	68	Seattle	63
Knoxville	52	St. Louis	85

3. Calendar year total liabilities for each tax were allocated to each state based upon data on tax bases by state for 1984 from the Advisory Commission on Intergovernmental Relations (ACIR). As no data are available on excise taxes collected on telephone use by state, personal income from the Commerce Department's Bureau of Economic Analysis was used as the base to allocate the telephone excise tax. The income tax offset was allocated according to the sum of 1984 federal income and employment taxes from the U.S. Census' *State and Metropolitan Area Data Book, 1986*.[8]

4. In each case, the tax per household by state was calculated using projected numbers of households for calendar year 1988. The projections were based upon recent Census projections for the total United States and allocated according to the most recent Census data (for 1986) on numbers of households by state. (The Census reports that there are just under 89 million households in the United States and that the average number of people per household is about 2.7.)

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[8] After reviewing the data, subjective corrections were made to data for New Hampshire (spirits, wine, beer, and cigarettes), the District of Columbia (spirits and wine), and Nevada (spirits and wine). The first two are excise tax havens for Massachusetts and Virginia, respectively, and the figures for Nevada are affected by the tourist trade. The corrections--details of which are available from the authors of the study--are necessary to convert ACIR data based primarily on sales in the state to figures closer to consumption by state.

5. Estimates for selected urban areas were then prepared in four steps. This methodology exploits consumption data that are available for regions and urban areas, but not for states.[9]

   i. The state data on excise increases above were aggregated to construct regional averages per household for the four national regions (northeast, midwest, south, and west) for which consumer expenditure data are available from the Bureau of Labor Statistics' Consumer Expenditure Survey.

   ii. Regional expenditures per household for all households in 1982-83 for each taxed item, as well as for income, were estimated by calculating the ratio of 1984 spending (and income) of "all consumers" to "urban consumers" and applying this ratio to spending data for urban consumers by region in 1982-83.

   iii. The ratio of consumer expenditures per household for each taxed item (and income) in each of the selected SMSAs in 1982-83 to those in the region, prepared in step ii, was calculated.

   iv. Finally, the tax per household in each SMSA (for each taxed item) was calculated by applying the ratio of SMSA to regional spending calculated in step iii to the regional tax data prepared in step i.

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[9] Consumption data were unavailable for Memphis and Knoxville. For this reason, the estimates for these two urban areas are based upon a different methodology that utilize local income data and state and regional spending patterns. Details are available from the authors.

APPROXIMATE EXCISE TAX BURDEN
PER HOUSEHOLD, 1988

State	State Tax[1]	Federal Tax		Total[4]
		Existing[2]	Proposed[3]	
Alabama	$562	$330	$264	$1156
Alaska	374	490	360	1225
Arizona	422	363	290	1075
Arkansas	393	331	271	995
California	266	392	299	957
Colorado	273	376	285	934
Connecticut	737	422	283	1442
Delaware	401	422	320	1142
Dist. of Colum.	661	374	246	1281
Florida	439	354	272	1066
Georgia	318	386	297	1001
Hawaii	592	373	274	1239
Idaho	351	340	285	976
Illinois	454	377	276	1106
Indiana	279	367	292	938
Iowa	364	351	281	996
Kansas	349	362	280	990
Kentucky	408	362	290	1060
Louisiana	482	370	304	1157
Maine	494	364	284	1142
Maryland	560	408	290	1258
Massachusetts	370	420	295	1085
Michigan	325	374	281	980
Minnesota	543	383	287	1213
Mississippi	307	334	274	915
Missouri	232	361	291	884
Montana	464	378	328	1169
Nebraska	421	362	289	1072
Nevada	989	392	335	1716
New Hampshire	578	392	285	1254
New Jersey	703	421	299	1423
New Mexico	419	342	306	1067
New York	407	359	239	1006
North Carolina	397	361	285	1043
North Dakota	417	390	318	1126
Ohio	443	350	278	1071
Oklahoma	447	359	288	1094
Oregon	258	339	279	876
Pennsylvania	470	335	254	1059
Rhode Island	489	366	277	1131
South Carolina	439	368	295	1102
South Dakota	460	367	299	1126
Tennessee	365	349	281	995
Texas	565	385	317	1266
Utah	354	327	254	935
Vermont	770	380	306	1457
Virginia	444	394	295	1133
Washington	496	341	266	1103
West Virginia	470	293	239	1002
Wisconsin	447	370	291	1108
Wyoming	297	462	396	1154
US Average	424	371	284	1079

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[1] Fiscal 1986 revenues, from U.S. Census Bureau. No projection available for 1988.

[2] Fiscal 1986 revenues, from OMB, allocated by QFA. Fiscal 1988 projected by OMB to be 1.5 percent higher.

[3] Calendar 1988 Liabilities, allocated by QFA.

[4] Details may not add to totals due to rounding.

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United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510-6200

June , 1987

The Honorable Robert C. Byrd
United States Senate
Washington, D.C. 20510

Dear Mr. Leader:

Last year, the Senate voted overwhelmingly for tax reform, in large part because it was designed to improve the fairness of the tax code. Congressional supporters of that legislation attached great importance to the tax reduction that would be provided to middle and lower income families and to the removal of six million low income Americans from the income tax rolls.

Yet this year, there is talk of eroding whatever gains were achieved in tax reform -- not by overtly repealing low-income tax relief, but by raising a number of excise taxes. Although a variety of rationales are presented for increasing one or another excise tax, the bottom line is this, excise taxes are regressive. Increasing them will eliminate most of the important results from tax reform.

The Congressional Budget Office recently prepared a study, "The Distributional Effects of an Increase in Selected Excise Taxes" which measures the distribution of federal taxes on beer, wine, liquor, tobacco, gasoline, airfare, and telephone service. This study illustrates just how quickly gains from tax reform can be taken back from low and moderate income families if Congress focuses on excise taxes to meet the deficit reduction targets this year.

The report shows that for families with less than $5,000 of income, each tax constitutes from 5 to 15 times as high a percentage of income as for families in the $50,000 and above category. Taken together, these seven taxes amount to nearly 5 percent of income for the poorest families. Even modest increases in these taxes will more than offset the average income tax relief provided to low income families in tax reform.

The Honorable Robert C. Byrd
June , 1987
Page two

It is also important to remember that state and local governments have traditionally relied on excise taxes for a large part of their revenue mix. With the elimination of General Revenue Sharing and many other federal programs, excise taxes have become an even more important financing mechanism to enable the states to take on the responsibilities abandoned by the federal government. Any effort by Congress to raise federal excise taxes will inevitably diminish the ability of state and local governments to finance the delivery of vital public services.

We believe Congress should resist focusing on excise taxes as a means to bridge the budget gap. In meeting the revenue instructions under the budget resolution, we should consider who will pay the higher taxes and reject a backhanded repeal of tax reform for low and moderate income families.

Sincerely,

George Mitchell

John Breaux

Bob Kasten

Terry Sanford
Chic Hecht

Paul Trible
Dale Bumpers

Carl Levin
Strom Thurmond
Orrin Hatch
Mitch McConnell

STATEMENT OF HON. TERRY SANFORD, U.S. SENATOR FROM THE STATE OF NORTH CAROLINA

Senator **Sanford**. Thank you very much. Let me simply endorse what my colleagues have said, the distinguished senior Senator from North Carolina and the distinguished Senator from Kentucky, that excise taxes are regressive and the burden is put in the wrong place, that increased excise taxes would reduce State revenues, and furthermore, the consumer tax largely has been a State area of revenue, more than the Federal Government.

Finally, cigarette taxes put an unnecessary burden on a group of people who really can't stand an additional burden, and those are the farmers. I think we need to quit treating tobacco farmers as villains.

They are attempting to meet the requirements of the tobacco programs and have done a good job of it. The tobacco program is not a program that costs the government money. To see tobacco as something to be taxed because of health considerations is simply not a fair way to go about assessing taxes.

I wanted to take this opportunity to endorse fully what my colleagues have said, and I ask that my statement regarding excise taxes be placed in the record.

The **Chairman**. Without objection.

Senator **Sanford**. Now I would like to speak on behalf of several thousand other North Carolina farmers—and I am sure a good many farmers elsewhere. As we seek ways of enhancing revenues, I think there is another source of revenue that should be looked at. This source of revenue comes from a flagrant loophole that was not removed last year during the tax revision.

I refer to the so-called family farm exemption. The family farm exemption was created in 1919 to allow the small family farmer use of the simple cash method of accounting rather than the more complicated accrual method.

In 1976, the family farm cash accounting exemption was extended, but by that time we had a great many sizable corporate farms that qualified as family farms by virtue of their ownership structures alone

Originally, the family farm was defined as any farm that was owned by two or fewer unrelated family groups—obviously a device to give consideration to certain parts of the industry. No reference was made to the size of the farm.

Now, many farmers in North Carolina supply poultry to Holly Farms. Holly Farms is a public corporation that cannot be considered a family farm. Last year, Holly Farms paid 45 percent of its income in federal taxes. In constrast, the majority of the top 25 "family farms" in this country paid almost no federal taxes.

On page 154 of the Joint Committee on Taxation report, there is an estimate of the income that could be realized by the Federal government if the family farm loophole was realized. While I believe these revenues are much needed, I was, however, moved to speak this morning because I saw a prospectus of a competitor of Holly Farms advertising the sale of its stock based on the advantages of this tax loophole.

I will read you this rather flagrant expression of tax avoidance:

> Current deferred income taxes result from the use of cash basis accounting for income tax purposes, which is available to family held farming corporations. These current deferred income taxes are not normally payable in one year and historically have been deferred indefinitely.
>
> As defined by the Revenue Code, a corporation is a family-held farming corporation—as I have already said—in which two family groups can make up 50 percent.

Thus they get this tremendous advantage of a tax-free, interest-free loans so they can continue their operations.

In essence, this prospectus says, "We will never pay any taxes because of the way this special loophole permittees to account."

Small, truly family farms continue to have the advantage of the cash accounting method and should, but Holly Farms and other major poultry processing corporations don't have it. Nonetheless Holly Farms competes with other billion dollar companies that do take advantage of the family farm loopholes.

The family farm loophole is one of the loopholes that is clearly set out in your committee print. I hope that you will consider that, in all fairness we look back and consider what we didn't do last year with the Tax Reform Act—we didn't look at the family farm exemption. We must indeed see this as a disadvantage, an unfair advantage, not only to farmers in North Carolina and farmers elsewhere who have companies that do not qualify, but strictly unfair to the taxpayers.

There is a proposal before the committee to close the family farm loophole and I take this opportunity—and I appreciate it—to say that I hope you will look at this loophole as one source of revenue for balancing our budget in 1988.

Thank you.

The CHAIRMAN. Thank you very much, Senator, for your comments. Congressman Dymally?

[The prepared written statements of Senator Sanford follow:]

SENATOR SANFORD'S TESTIMONY TO
THE SENATE FINANCE COMMITTEE
EXCISE TAXES
JULY 15, 1987

As a member of the Senate Budget Committee, I know well the difficulty of the choices you face. After making the hard choices about spending cuts, I do not envy you your hard choices about revenue increases.

No tax is popular or easy. The best you can do, as you well realize, is to find a source of revenue that poses no unfair burden on anybody, that taxes people according to their ability to pay. With this principle in mind, I would urge you not to increase excise taxes.

There are three major reasons to oppose increased excise taxes.

1. EXCISE TAXES ARE REGRESSIVE

First, excise taxes are regressive, falling hardest on those least able to pay. A study released in January by the Congressional Budget office warned that, when taken as a percentage of income, increased taxes on tobacco and beer would pose a burden three times greater for families making between $10,000 and $20,000 than for families with incomes over $50,000. The study noted that, of all excise taxes, an increase in the tobacco tax would be the most regressive.

Increasing excise taxes would only move us away from the historic steps Congress took last year to make our tax code fairer. A $10 billion increase in excise taxes would completely wipe out the tax cut approved last year for families making under $10,000. It would take away most of the tax cut for those with incomes between $10,000 and $40,000. Meanwhile, the fortunate few who make over $100,000 would come out ahead.

It is important to remember that, despite last year's tax reform bill, working families are still shouldering a large tax burden. Over the last 30 years, the tax burden has shifted sharply away from the wealthy and corporations and onto middle-income taxpayers. In the 1950s, individual income and social security taxes contributed 55 percent of all federal revenues. By 1980, this had grown to 78 percent.

This burden has increasingly been assumed by middle- and lower-income taxpayers. Between 1978 and 1981 alone, the real tax burden of the bottom half of taxpayers increased by 50 percent. During this same period, the effective tax rate for people making over $200,000 fell by 16 percent.

This shift was only hastened by the 1981 tax bill, which further skewed the tax burden toward those least able to pay. The 1986 tax bill was a start at reversing this trend. Let's not undo that good work.

2. INCREASED EXCISE TAXES WOULD REDUCE STATE REVENUES

Second, increasing federal excise taxes would reduce state revenues in two ways. First, it would further preempt state excise taxes, traditionally an important revenue source for the states.

Second, by reducing the consumption of these taxed goods, it would reduce the state excise taxes they generate. The National Governors Association has estimated that doubling the federal excise tax on cigarettes would result in an immediate loss of $200 million to the states. This is equivalent to wiping out all current EDA funds for state and local public works projects.

The National Conference of State Legislatures opposes increased excise taxes, both because they are regressive, and because they would cost the states revenues.

3. INCREASED CIGARETTE TAXES WOULD OVERBURDEN TOBACCO FARMERS

And third, to focus on a specific excise tax, I would like to point out that further increases in the tobacco tax would cause undue hardship on tobacco farmers.

The tobacco tax was doubled in 1982, and tobacco is already the most heavily taxed product in America. The federal government now earns about 3.5 times as much as the farmer from every acre of tobacco. Any increase in the government's share will come directly at the expense of the farmer.

Let me remind the committee that the tobacco program now operates at no net cost to the taxpayer. Every tobacco farmer pays an assessment to underwrite the cost of the support price. In addition, tobacco farmers recently agreed to a number of tough measures, including reduced quotas and lower support prices, to keep the tobacco program on a break-even basis.

Tobacco farmers are doing their share. Unlike any other farm group, they finance their own price support program, and they withstand steep local, state and federal taxes. But enough is enough. They are at the breaking point now. Another blow, such as increased tobacco taxes, could drive many families off their farms.

SUMMARY

Again, I would like to thank the committee for this chance to testify about possible revenue sources. And I would again urge you to oppose increased excise taxes because of the hardships this increase would place on three groups: middle- and lower-income families, the states, and the farmers.

SENATOR SANFORD'S TESTIMONY TO
THE SENATE FINANCE COMMITTEE
FAMILY FARM TAX LOOPHOLE
JULY 15, 1987

I want to commend the Chairman for holding these much needed hearings on revenue raising measures and I would like to thank both the Chairman and the distinguished members of the Committee for allowing me to testify this morning. My distinguished colleague, Senator Helms, spoke earlier about excise taxes and I should mention that I share his position on that issue and commend his testimony to you, but now I want to talk about chickens.

To be a little more precise, I would like to suggest a way for the Committee to save our government approximately $100 million a year over the next five years. This can be done easily and fairly enough if we are willing to alter the definition of a Family Farm in our tax code. I propose this redefinition so that the term Family Farm will come to reflect more closely the intent of its original authors. I have looked closely at the legislative history of the provisions relating to family farms and have come to the clear conclusion that the Congress did not intend huge multi-million dollar a year revenue earners be deemed "family farms," deserving of exemptions from accounting methods considered too complicated for the small family farmer.

In 1919, the Congress created the family farm concept to give small, unsophisticated family farmers the right to use the simple cash accounting method in calculating their income for tax purposes. Such businesses generally did not have the ability to manage their books using the more complicated accrual method of accounting even though the accrual method more accurately matches a company's expenses to its revenues. In other words, the family farm concept was designed to give the little guy a break.

Under a provision added to the Code by the Tax Reform Act of 1976, farm corporations with earnings in excess of $1 million a year had to adopt the accrual method of accounting in keeping their books. However, in this same provision an exception was granted to family farms again recognizing the burden that the accrual method represents to small agri-business interests. I would like to read two brief excerpts from the House Report to the '76 Reform Act which provide additional insight into the origins of the family farm exception:

> The opportunity for farmers generally to use the cash method of accounting..... was granted over 50 years ago by administrative rulings. These rulings were issued at a time when most agricultural

> operations were small operations carried on by individuals. The primary justification for the cash method of accounting for farm operations was its relative simplicity.....

Two paragraphs later, after noting that in recent years "many corporations [had] entered farming," the House Report stated:

> [I]t is appropriate to require corporations..... engaged in farming to use an accrual method of accounting..... Your committee, however, has excepted from this requirement small or family corporations in order to continue the cash basis method essentially for all but the larger corporations engaged in farming.

The intent of the Congress was clear and, I believe, reasonable. That is, require accrual accounting for farming corporations that, based on their size, could be expected to have the sophistication and resources available to apply the accrual method.

As I implied before, the problem with the Family Farm concept lies in the definition of a Family Farm itself. The term is defined solely by reference to the ownership structure of the entity concerned; no reference to the size of such an entity is made in defining this term. As a result, a loophole was inadvertently created in 1919 and retained in the 1976 Tax Act. This loophole allows closely-held family farms of any size an exemption from the accrual method of accounting applicable to all other farms with earnings in excess of $1 million, so long as at least half of their stock is owned by members of two unrelated family groups.

Today I know of only 3 or 4 poultry processing companies in the top 20 that do not utilize this loophole to take interest free multi-million dollar loans from the U.S. taxpayer. I do not believe, nor do I think the average American taxpayer believes, that the poultry industry in this country needs a subsidy out of taxpayers' pockets to maintain itself. In fact, the second and third largest poultry processors in this country, Con Agra and Holly Farms, manage reasonably well without this subsidy. And yet the largest processor of poultry products in this country, with over $1.4 billion in revenues for 1986 deferred, or borrowed, depending on how you look at it, $37.6 million last year because of this loophole. The year before it deferred more than $20 million in government taxes. The amount this same company has borrowed or deferred over the years exceeded $103 million at the end of last year. Tysons Foods, Pilgrims Pride and Hudson Foods are only a few of the top twenty companies taking loans free from the taxpayers pocket and contributing to our widely recognized budget problems. Because of the nature of cash accounting, these interest free loans are also perpetual as long as the loophole user maintains or increases sales yearly. This means that, not only are taxpayers picking up the interest on these loans, but they are collectively sacrificing the time value of money on these assets as inflation slowly eats away the real value of the dollars originally lent to these poultry processors.

The loophole generated incentive for processors to grow so as to continue realizing their perpetual tax deferrals also contributes to an artificial growth in poultry supply which doesn't necessarily match market demands for poultry. The result can be cyclical price depressing poultry gluts. Cash accounting on this scale also tends to create huge fluctations in the demand for and price of feed as loophole users concentrate their feed buying near the end of tax periods to boost their expenses. The irony of all these loophole induced feed and poultry price swings is that they hurt the small farmers that the family farm concept was originally intended to help.

The proposal I wish to put in front of the committee would simply modify the current definition of a Family Farm in the tax code by putting a dollar limit on the size of an entity entitled to the benefits of the family farm provision. While my reading of the original Family Farm legislation intent would suggest that cash accounting be available only to Family Farms with revenues of a much smaller amount, political reality requires that I propose a cap at $100 million a year in revenues. The $100 million dollar cap proposed would directly effect only to the largest poultry processors while retaining the provision for small farmers.

Moreover, my proposal would put poultry processors such as Con Agra and Holly Farms on an equal footing with their competitors who currently have a distinct advantage only by virtue of their access to the loophole in question.

Finally, while the current large loophole user would certainly like to retain this free loan advantage, this same advantage is not one that the industry needs in order to protect the small farmers with whom they contract. The method of accouting employed by a billion dollar company simply does not have a significant effect on the persons that it may contract with or otherwise employ. After all, the growers that contract with Con Agra and Holly Farms are not apparently affected in any way by the methods of accounting used by those companies.

In closing I will only say that last year Congress enacted a true tax reform bill; a bill that made real headway in cutting out tax subsidies and loopholes, including some that benefited some very large interest groups. In this vein I am asking that this committee pursue the objective of fiscal fairness and close a loophole that has no social or economic justification-- a loophole that truly benefits only a very privileged group of taxpayers at the expense of a great many tax paying Americans. At a time when the Congress is seeking fair and effective ways of raising revenues to reduce our budget deficit, I urge you to consider placing a cap on the total revenues of our so-called "family farms" to ensure that our largest farmers do not unfairly benefit from tax benefits designed for the true small, family farmer.

Thank you very much.

STATEMENT OF HON. MERVYN M. DYMALLY, U.S. CONGRESSMAN FROM THE STATE OF CALIFORNIA

Congressman DYMALLY. Thank you, Mr. Chairman and members of this distinguished committee.

As the representative for thousands of working class Americans in Los Angeles County, and as Chairman of the Congressional Black Caucus, I watched with interest the passage of the Tax Reform Bill of 1986 as a means of affording a measure of relief for poor people.

The most attractive part of that legislation was the removal of more than four million of the working poor from the Federal tax rolls, along with the reduced tax burden for other low-income American families.

The byword for the 1986 tax legislation was "fairness," and as law, it has been fair—at least for the lower brackets. But now in 1987, Mr. Chairman, Congress is looking to take back what it gave to the poor in 1986.

The revenue shortfall and immense budget deficit looming over this Congress have sent many of my fellow members in a frantic search for more revenue and for many reasons—because it is easy, because it seems to be nickel-and-dime taxation, or because the people who are hurt by it are not organized to protest. Too many are looking to a rise in excise taxes, this, Mr. Chairman, despite clear evidence that this method places the burden on those least able to bear it.

The regressive nature of excise taxes has been well documented. For our purposes, this conclusion has been confirmed in the preliminary draft of a major report on revenue options prepared for the Congressional Black Caucus and to be released next week.

The "Task Force Report" demonstrates precisely who is paying when excise taxes are increased.

In general, Mr. Chairman, the proposed increases in excise taxes would be approximately twice as large for families with incomes between $10,000 and $20,000, compared to families with incomes of $50,000 or more.

According to a 1987 staff working paper report of the Congressional Budget Office, families with incomes of less than $5,000 spend 17 percent of their income on gasoline, compared with just over two percent for families with incomes of $50,000 or more.

An increase in the tax on tobacco would raise taxes as a percent of expenditures by more than twice as much for families with incomes below $10,000 than for families of $50,000 or more.

And any increase in excise taxes for telephone service or alcoholic beverages would also hit low income families disproportionately.

The Congressional Black Caucus' interest in this issue is enormous. 7.2 million poor families lived in this country as of 1985. And although numerically there are more whites in poverty than minorities, the proportion of blacks and other minorities in poverty is greater than that of whites.

But for all poor families, even a modest increase in excise taxes will take more than all of the tax relief afforded them in the 1986 tax bill.

These increases will cost the poor five times as much—nearly $2 billion—as they would receive in income tax cuts from the Tax Reform Act of 1986.

This will considerably magnify the incidence, prevalence, and the enormity of poverty in the United States.

We are not protesting an increase in excise taxes without offering other alternatives for raising revenue. While the excise tax is by its nature the most regressive of taxes, the Federal income tax is the most progressive. Several measures can be taken which improve the progressivity of last year's Tax Reform Bill.

For example, while the Tax Reform Act of 1986 brought fairness to the lower brackets, it was arguably too fair to the higher brackets. Speaker Wright has suggested freezing the income tax rate for high income individuals in the top bracket at 38 percent, rather than allowing it to fall to 28 percent.

This measure alone would bring in more than $22 billion or $2.7 billion more than the revenue we are seeking.

As another idea, the top estate tax rate is scheduled to be reduced from 55 percent to 50 percent. If this rate is frozen at 55 percent, we can save $2 billion over the next five years.

Finally, Mr. Chairman, closing the loophole which allows wealthy individuals to sell stock to employee stock ownership plans and escape taxation would provide $5 billion over three years.

I urge careful attention to your Task Force Report, Mr. Chairman, and I plan to leave a copy with you.

A committee which distinguished itself last year as a bastion of fairness cannot and should not renege on that commitment. Abandoning moral responsibility in pursuit of short-term fiscal solutions cannot be the goal of this committee or the Congress.

I thank you very much, Mr. Chairman, and I shall be pleased to leave a copy of the Task Force Report for the record.

The CHAIRMAN. We will be glad to have it and put it in the record. Thank you.

Congressman DYMALLY. Thank you very much.

The CHAIRMAN. Congressman Gregg from the State of New Hampshire, we are very pleased to have you. Would you proceed?

[The prepared statement of Congressman Dymally and the Task Force Report follow:]

STATEMENT OF
THE HONORABLE MERVYN M. DYMALLY
CHAIRMAN CORESSIONAL BLACK CAUCUS
COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARINGS ON REVENUE OPTIONS
JULY 15, 1987

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

AS THE REPRESENTATIVE FOR THOUSANDS OF WORKING CLASS AMERICANS IN LOS ANGELES COUNTY, AND AS CHAIRMAN OF THE CONGRESSIONAL BLACK CAUCUS, I WATCHED WITH INTEREST THE PASSAGE OF THE TAX REFORM BILL OF 1986 AS A MEANS OF AFFORDING A MEASURE OF RELIEF FOR POOR PEOPLE. THE MOST ATTRACTIVE PART OF THAT LEGISLATION WAS THE REMOVAL OF MORE THAN FOUR MILLION OF THE WORKING POOR FROM THE FEDERAL TAX ROLES, ALONG WITH THE REDUCED TAX BURDEN FOR OTHER LOW-INCOME AMERICAN FAMILIES. THE BYWORD FOR THE 1986 TAX LEGISLATION WAS FAIRNESS, AND AS LAW, IT HAS BEEN FAIR — AT LEAST FOR THE LOWER BRACKETS.

BUT NOW IN 1987, CONGRESS IS LOOKING TO TAKE BACK WHAT IT GAVE TO THE POOR IN 1986. THE REVENUE SHORTFALL AND IMMENSE BUDGET DEFICIT LOOMING OVER THIS CONGRESS HAS SENT MANY OF MY FELLOW MEMBERS IN A FRANTIC SEARCH FOR MORE REVENUE. AND FOR MANY REASONS — BECAUSE IT'S EASY, BECAUSE IT SEEMS TO BE NICKEL-AND-DIME TAXATION, OR BECAUSE THE PEOPLE WHO ARE HURT BY IT ARE NOT ORGANIZED TO PROTEST -- TOO MANY ARE LOOKING TO A RISE IN EXCISE TAXES. THIS, DESPITE CLEAR EVIDENCE THAT THIS METHOD PLACES THE BURDEN ON THOSE LEAST ABLE TO BEAR IT.

THE REGRESSIVE NATURE OF EXCISE TAXES HAS BEEN WELL DOCUMENTED. FOR OUR PURPOSES, THIS CONCLUSION HAS BEEN CONFIRMED IN THE PRELIMINARY DRAFT OF A MAJOR REPORT ON REVENUE OPTIONS PREPARED FOR THE CONGRESSIONAL BLACK CAUCUS AND TO BE RELEASED NEXT WEEK. THE "TASK FORCE REPORT" DEMONSTRATES PRECISELY WHO IS PAYING WHEN EXCISE TAXES ARE INCREASED.

IN GENERAL, THE PROPOSED INCREASES IN EXCISE TAXES WOULD BE APPROXIMATELY TWICE AS LARGE FOR FAMILIES WITH INCOMES BETWEEN $10,000 AND $20,000 COMPARED TO FAMILIES WITH INCOMES OF $50,000 OR MORE. ACCORDING TO A 1987 STAFF WORKING PAPER REPORT OF THE CONGRESSIONAL BUDGET OFFICE, FAMILIES WITH INCOMES OF LESS THAN $5,000 SPEND 17 PERCENT OF THEIR INCOME ON GASOLINE COMPARED WITH JUST OVER 2 PERCENT FOR FAMILIES WITH INCOMES OF $50,000 OR MORE. AN INCREASE IN THE TAX ON TOBACCO WOULD RAISE TAXES AS A PERCENT OF EXPENDITURES BY MORE THAN TWICE AS MUCH FOR FAMILIES WITH INCOMES BELOW $10,000 THAN FOR FAMILIES OF $50,000 OR MORE. AND ANY INCREASE IN EXCISE TAXES FOR TELEPHONE SERVICE OR ALCOHOLIC BEVERAGES WOULD ALSO HIT LOW-INCOME FAMILIES DISPROPORTIONATELY.

THE CONGRESSIONAL BLACK CAUCUS' INTEREST IN THIS ISSUE IS ENORMOUS. 7.2 MILLION POOR FAMILIES LIVED IN THIS COUNTRY AS OF 1985, AND ALTHOUGH NUMERICALLY THERE ARE MORE WHITES IN POVERTY THAN MINORITIES, THE PROPORTION OF BLACKS AND OTHER MINORITIES IN POVERTY IS GREATER THAN THAT OF WHITES. BUT FOR ALL POOR FAMILIES, EVEN A MODEST INCREASE IN EXCISE TAXES WILL TAKE MORE THAN ALL OF THE TAX RELIEF AFFORDED THEM IN THE 1986 TAX BILL. THESE INCREASES WILL COST THE POOR FIVE TIMES AS MUCH — NEARLY $2 BILLION -- AS THEY WOULD RECEIVE IN INCOME TAX CUTS FROM THE REFORM ACT OF 1986. THIS WILL CONSIDERABLY MAGNIFY THE INCIDENCE, PREVALENCE AND THE ENORMITY OF POVERTY IN THE UNITED STATES.

WE ARE NOT PROTESTING AN INCREASE IN EXCISE TAXES WITHOUT OFFERING OTHER ALTERNATIVES FOR RAISING REVENUE. WHILE THE EXCISE TAX IS BY ITS NATURE THE MOST REGRESSIVE OF TAXES, THE FEDERAL INCOME TAX IS THE MOST PROGRESSIVE. SEVERAL MEASURES CAN BE TAKEN WHICH IMPROVE THE PROGRESSIVITY OF LAST YEARS' TAX REFORM BILL.

FOR EXAMPLE, WHILE THE TAX REFORM ACT OF 1986 BROUGHT FAIRNESS TO THE LOWER BRACKETS, IT WAS ARGUABLY "TOO" FAIR TO THE HIGHER BRACKETS. SPEAKER WRIGHT HAS SUGGESTED FREEZING THE INCOME TAX RATE FOR HIGH INCOME INDIVIDUALS IN THE TOP BRACKET AT 38 PERCENT, RATHER THAN ALLOWING IT TO FALL TO 28 PERCENT. THIS MEASURE ALONE WOULD BRING IN MORE THAN $22 BILLION, OR $2.7 BILLION DOLLARS MORE THAN THE REVENUE WE ARE SEEKING. AS ANOTHER IDEA, THE TOP ESTATE TAX RATE IS SCHEDULED TO BE REDUCED FROM 55 PERCENT TO 50 PERCENT. IF THIS RATE IS FROZEN AT 55 PERCENT, WE CAN SAVE $2 BILLION OVER THE NEXT FIVE YEARS. AND FINALLY, CLOSING THE LOOPHOLE WHICH ALLOWS WEALTHY INDIVIDUALS TO SELL STOCK TO EMPLOYEE STOCK OWNERSHIP PLANS AND ESCAPE TAXATION WOULD PROVIDE $5 BILLION OVER THREE YEARS.

I URGE CAREFUL ATTENTION TO OUR TASK FORCE REPORT. A COMMITTEE WHICH DISTINGUISHED ITSELF LAST YEAR AS A BASTION OF FAIRNESS CANNOT AND SHOULD NOT RENEGE ON THAT COMMITMENT. ABANDONING MORAL RESPONSIBILITY IN PURSUIT OF SHORT-TERM FISCAL SOLUTIONS CANNOT BE THE GOAL OF THIS COMMITTEE OR THIS CONGRESS.

THANK YOU.

A TASK FORCE REPORT

ON

AN EVALUATIVE ANALYSIS OF THE POSSIBLE IMPACT OF FEDERAL EXCISE TAXES ON THE POOR, INCLUDING BLACKS AND OTHER MINORITIES

PREPARED FOR
CONGRESSMAN MERVYN M. DYMALLY
CHAIRMAN
CONGRESSIONAL BLACK CAUCUS

JULY 1987

Executive Summary

Approximately 200 proposals have been submitted in the 100th U.S. Congress geared to raise revenue and to reduce the Federal deficit. This report makes an evaluative analysis of the possible impact of Federal excise taxes on the poor, including blacks and other minorities.

Federal excise taxes are regressive. They are also hidden, thereby challenging the much valued openness in government. A proposed increase in the traditional Federal excise taxes of energy, tobacco, wine, beer and spirits is considered to be markedly regressive. The average increase in taxes would be approximately twice as large (more than three times as large in the case of the tax on beer or tobacco) for families with incomes between $10,000 and $20,000 compared to families with incomes of $50,000 or more.

According to a 1987 Staff Working Paper Report of the Congressional Budget Office:

1. Families with incomes of less than $5,000 spend 17 percent of their income on gasoline compared with just over 2 percent for families with incomes of $50,000 or more.
2. Families with incomes under $10,000 account for a much larger share of tobacco and slightly larger share of beer expenditures than their share of total expenditures.
3. Families with incomes of less than $10,000 pay at least 10 percent to 12 percent of excise taxes on gasoline and alcohol beverages and 15 percent of the tax on tobacco.
4. An increase in the tax on tobacco would raise taxes as a percent of expenditures by more than twice as much for

families with incomes below $10,000 than for families of $50,000 or more.

Increases in taxes will seemingly exacerbate the already sad plight of the poor, particularly blacks and Hispanics as inferred from the following:

1. The estimated median income for white families in 1985 was $29,150 compared to the Spanish speaking median family income of $19,030 and the median income of black families of $16,790.
2. The real per capita income in 1985 in the U.S. was $11,010 with the per capita income of whites estimated at $11,670 and that of blacks $6,610.
3. With a poverty threshold of $10,989 for a family of three, 33.1 million persons or 14 percent were below the poverty level in 1985.
4. 22.9 million whites or 11.4 percent were in poverty contrasted with 8.9 million blacks or 31.3 percent and 5.2 million Spanish origin persons of mixed racial origins or 29.0 percent.
5. The number of poor families in the United States in 1985 was 7.2 million. Almost one half of these had female head of household.

Numerically, therefore, there are predominantly more whites in poverty in the United States than there are blacks and other minorities. The proportion of blacks and other minorities in poverty, however, is greater than that of whites.

An examination of the minimum wage level shows that there are 6.7 million men and women who earn the minimum wage of $3.35 an hour or less with a consequent annual earning power of $400 below the poverty line for a worker with a single dependent and $1,870 below the poverty line for a family of three.

It is of significance that the total number of workers who are living below the poverty level increased from 6.7 million in 1975 to 9.1 million in 1985. It is of overall significance that even modest increases in excise taxes will take more than all of the tax relief afforded to the poor by the 1986 tax reform bill. More specifically, it will cost the poor five times as much -- nearly $2 billion -- as they would receive in income tax cuts from the Tax Reform Act of 1986. This will considerably magnify the incidence, prevalence and the enormity of poverty in the United States.

Combinations of the following options that will increase progressivity and decrease regressivity are hereby urgently suggested:

1. Freezing the income tax rate for high income individuals in the top bracket at 38.5 percent.
2. Reducing the corporate tax rate to 38.4 percent, rather than 34 percent.
3. Holding at 55 percent instead of reducing to 50 percent in 1985, the top estate rate.
4. Closing the loophole in the 1986 Tax Reform Bill of allowing estates to escape taxation by selling stock to employee stock ownership plans.

I. Introduction

It has been amply demonstrated that blacks and other minorities have accepted their full responsibilities as citizens of the United States including that of paying their fair share of taxes and subscribing to other revenue bearing measures. Because of the general low socio-economic status of blacks and other minorities in the United States, it is of significance that taxes and other revenue raising measures be somewhat progressive and be based upon the ability to pay.

Approximately 200 proposals have been submitted to the 100th Congress geared to raise revenue and to reduce the federal deficit. This report, however, will address itself mainly to one category of these proposals and, as a consequence, will make an evaluative analysis of the possible impact of federal excise taxes on the poor, including blacks and other minorities. This analysis will include the following:

1. An analysis of the major Federal Excise Taxes in terms of regressivity;
2. An analysis of the socio-economic status of blacks and Hispanics in terms of the possible impact of the Federal Excise Tax on these minorities;
3. A discussion of selected less regressive revenue raising options.

The Congress of the United States, after approving a $1 trillion spending plan, is currently attempting to raise approximately $19.3 billion in taxes for 1988 and $64.3 billion over the next three years. The process calls for the recommendation of specific revenues from the tax writing committees of the U.S. House of Representatives and the U.S. Senate. As a consequence, considerable interest has been shown in the utilization of excise taxes as a means of raising the above referenced amount and, in the process, reducing federal budget deficits. Because of the recency of the tax reform legislation of 1986, many legislators are somewhat reluctant to seek further changes in increased tax rates. Despite the fact that if excise taxes are relied upon to raise the full $19.3 billion in taxes for 1988, these taxes will virtually wipe out the average tax reduction received by low and middle-income tax payers under last year's tax reform legislation. It will also keep intact most of the tax cuts for upper-income people. Moreover, studies have shown that people tend to be more concerned with tax fairness than with tax rates and, therefore, the equitable and fair distribution of revenue increases rather than changes in tax rates per se.

The present concern with excise taxes does not seem to comply with fairness because of its regressivity and because they are hidden, thereby challenging the much valued openness in government. If, therefore, Congress raises excise taxes as currently discussed, the poor will lose twice what they gained by the tax reform of 1986. The American people will, therefore, be opposed to a tax revenue approach that secretly raises money on the backs of the poor.

According to Charles E. McLure, a former deputy assistant secretary for tax policy at the U.S. Treasury Department, in a study for the American Enterprise Institute:

> Resort to excises as an important source of revenues is usually associated with developing countries that lack the administrative capacity to impose better taxes...The Federal government of the United States clearly does not fit that description.[1]

It is of significance that the average U.S. household currently pays $370 annually in 1986 dollars under current federal tax law for federal excise taxes. Additionally, every state has imposed some excise taxes. In 1986, total federal, state, and local excise taxes amounted to $790 per household.

Federal excise taxes are scheduled to rise by more than 75 percent in the current proposal now discussed with the different components distributed as follows:[2]

Gasoline	increase of	111	percent
Cigarettes	increase of	200	percent
Beer	increase of	306	percent
Table wine	increase of	1733	percent
Distilled spirits	increase of	20	percent

The major excise taxes of energy, distilled spirits, beer, wine and tobacco will herein be examined in terms of their impact on the poor.

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[1] Quoted from statement of Rev. Robert J. McEwen, Chairman of Consumers Opposed to Secret Taxes of June 4, 1987.

[2] See Federal Excise Taxes: Cost to Average American Households, prepared for the COST Coalition by Quick, Finan and Associates, p. 2.

II. The Regressive Aspects of the Major Federal Excise Taxes

A. Energy Taxes

The United States depends on foreign sources for about 19 percent of its total energy and for about 29 percent of the oil it consumes. An energy excise tax must, therefore, be weighed against these facts. In addition, energy taxes constitute a larger proportion of family incomes for low income tax payers who spend a high percentage of their meagre income on energy. An increase in fuel oil will exert a particular hardship on low income people in both rural and urban areas particularly during the Winter months. Moreover, an excise tax on foreign petroleum might very well be in violation of the rules of the General Agreement on Tariffs and Trade (GATT) particularly if a higher tax is levied on imported oil than on domestic oil. GATT regulations specify that taxes on imported products from any of the member countries must not be more than those applied to some domestic products.

With specific reference to gasoline taxes, it is felt that higher gasoline taxes would increase the tax burden on a commodity which is already heavily taxed. In addition to the 9 cents per gallon federal excise tax on gasoline and state excise taxes which average about 14 cents per gallon, companies dealing with the production and distribution of oil and oil products pay many other kinds of federal, state and local taxes. This includes severance and other production taxes and property taxes in addition to taxes such as the windfall profit taxes specifically applied to the petroleum industry. Moreover, per capita gasoline consumption in the southern and western states is significantly higher than in other regions of the country. As a consequence, consumers in the West and South would bear a disproportionately large share of the burden of additional federal motor fuel taxes with a high proportion of the poor and blacks residing in the South. The gasoline excise tax also has been shown to be highly regressive with gasoline consumption constituting a much higher percentage of the budets of low income families than of high income family budgets. Almost one fourth of the gasoline tax is borne by low to moderate income households while only 5 percent is borne by high income households. Additionally, a Congressional Budget Office report indicated that a gasoline tax increase as scheduled would cost families in the $10,000 to $20,000 income range about twice as much, relative to their income, as families with incomes over $50,000. More specifically, according to a study by Citizens for Tax Justice,

> If Congress were to meet its budget targets with a gasoline tax hike, families earning less than $10,000 would have to shell out 25 times as high share of their incomes in increased taxes as would rich people.[3]

In a similar vein, the same study refers to overall energy consumption as "extraordinarily regressive" and states further that,

> Because overall energy consumption is distributed much like gasoline consumption, the effects of an oil import fee would mirror those of a gasoline tax hike -- except that the magnitude would be almost three times as great for every

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[3] Citizens for Tax Justice, Meeting the Revenue Targets in the 1988 Budget: Will Tax Reform Be Extended or Undermined, Washington, D.C., May 1987, p. 5.

dollar collected in import taxes. Thus, poor families would lose more than 5 percent of their incomes to higher oil costs.[4]

B. Tobacco and Excise Taxes

The proposed increase in the excise tax on tobacco is generally considered to be the most regressive of all of the tax increases considered. As a percentage of income, the tobacco excise tax is 15 times higher for low income, under $5,000 families than for high income, over $50,000 families.[5] More specifically, whereas tobacco excise taxes average approximately 0.275 percent of the total income of all tax payers, in the lowest income class, the tax averages 1.3 percent of income. On the other hand, in the top income class, it averages only 0.035 percent of income. Moreover, 28.8 percent of tobacco excise taxes are paid by low to moderate income earners, thereby constituting a higher percentage than for any other tax except beer with 29.0 percent.[6] This regressivity will be incurred inspite of the fact that doubling this tax from 16 cents to 32 cents per pack will yield only $2.9 billion additional federal dollars. This doubling of the tax will also contribute to a loss of 28,500 jobs in the U.S. tobacco industry, resulting in the further untold suffering of more low income people who depend on the tobacco industry for their livelihood. As a case in point, R.J. Reynolds plans to cut 2,800 tobacco-related jobs by the end of 1987 to strengthen its competitiveness in the face of declining cigarette consumption. By April, 1987, jobs in tobacco manufacturing had decreased by 1,200 in North Carolina to 23,000 for a drop of 4.9 percent over the previous year.[7]

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[4] Citizens for Tax Justice (May 1987), p. 6.

[5] See Congressional Budget Office, The Distributional Effects of An Increase In Selected Federal Excise Taxes, January, 1987.

[6] The Policy Economics Group of Peat, Marwick, Main and Co., An Analysis of the Regressivity of Excise Taxes, May 1987, p. 21.

C. Liquor

As in the case of the tobacco industry, the liquor industry has shown somewhat of a decline in consumption with an apparent decrease of 6 percent since 1985. This is seemingly attributable mainly to a 19 percent increase in Federal excise tax which took place as recently as 1985. The liquor industry has experienced 16 fewer distilled spirits bottlers and producers in 1986 than in 1978. Moreover, 28 percent of the liquor manufacturing jobs available in 1978 were lost by 1984 with a further 5.4 percent job loss in 1985.

D. The Beer Industry

The future of the beer industry, now slowly recovering from declining sales, will be sorely threatened with an increase in federal excise taxes. This industry now employs more than 39,000 people with supporting jobs for more than a million and a generation of approximately more than $114 billion in economic activity in the United States.

Doubling the excise tax on beer from $9 to $18 per barrel would cost the economy of the United States about 9,000 jobs with about 6,400 jobs lost in the brewing industry. On the other hand, tripling the excise tax on beer from $9 to $27 per barrel would cost the economy of the United States an estimated 18,400 jobs with a specific loss of approximately 13,000 jobs in the brewing industry.

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[7] News and Observer, June 4, 1987.

Any of the above decisions will increase the ranks of the unemployed and the poor, including minorities and blacks in the United States, and significantly increase the regressivity of excise taxes on beer which now impose the heaviest burden on lower and middle-income households. As a consequence, the federal excise tax on beer is now regarded as one of the most regressive of all taxes, since beer has become institutionalized in the United States as the beverage of choice to lower income and working middle income Americans.

E. The Wine Industry

A similar pattern, as discerned in the beer industry, is found in the wine industry. From 1984 to 1986 the consumption of table wine produced in the United States decreased by 6 percent, from 283 million gallons to 267 million gallons, with a consequent abandonment of 79,000 acres of California vineyards alone in 1986. As in other cases, the excise tax increase on table wine will be passed on to the consumer and, as in other cases, will also fall particularly hard on lower and middle income consumers with a consequent 20 percent to 30 percent loss in sales volume and an estimated 34,000 loss in jobs in wine and associated industries. This further exacerbates the plight of the poor, including blacks and other minorities.

III. Congressional Budget Report

A staff working paper for the Congressional Budget Office on "The Distributional Effects of An Increase In Selected Federal Excise Taxes" shows the following as they relate to the regressivity of excise taxes on the seven commodities: beer, wine, liquor, tobacco, gasoline, air fare and telephone service but with specific reference to the first five, specifically alluded to in this study[8]:

1. An increase in the excise tax on tobacco would be the most regressive of all the tax increases taken into consideration.

2. In measuring the distributional effects relative to family income, it was ascertained that an increase in any of the taxes, except the airline ticket tax, would be noticeably regressive. Additionally, the average increase in taxes as a percentage of total income would be approximately twice as large (more than three times as large in the case of the tax on beer or tobacco) for families with incomes between $10,000 and $20,000 compared to families with incomes of $50,000 or more.

3. Families with incomes of less than $5,000 spend 17 percent of their income on gasoline compared with just over 2 percent for families with incomes $50,000 or more. Families in the lowest income class spend about 12 percent of their income on telephone service; families in the highest income class spend just under one percent.[9]

4. Families with incomes under $10,000 account for a much larger share of tobacco and telephone expenditures and a slightly larger share of beer expenditures compared to their share of total expenditures. Conversely, for all commodities, except wine and air fare, the share of

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[8] Congressional Budget Office, The Distributional Effects of an Increase In Selected Federal Excise Taxes, January 1987, pp. 1-35.

[9] Congressional Budget Office, January 1987, p. 8.

expenditures for families with incomes of $40,000 or more is less than their share of total expenditures.[10]

5. As a percentage of income, excise taxes are highest in the lowest income class for all seven types of expenditures.[11]

6. Tobacco excise taxes, as a percent of income, are less than one-fourth as large for families in the highest income class compared to families with incomes of $10,000 to $20,000.[12]

7. Families with incomes of less than $10,000 pay at least 10 percent to 12 percent of excise taxes on gasoline and alcoholic beverages. These families pay about 13 percent of the telephone excise tax and about 15 percent of the tax on tobacco. Families in the highest income class pay between 20 percent and 25 percent of most excise taxes, except those for airfare (31 percent) and tobacco (only 14 percent).[13]

8. An increase in the tax on tobacco would raise taxes as a percent of expenditures by more than twice for families with incomes below $10,000 than for families of $50,000 or more.[14]

9. The share of the tax increase for families with incomes of less than $10,000 would be the largest for tobacco taxes and the smallest for airfare taxes. Families with incomes between $10,000 and $30,000 would also fare the worst under a tobacco tax increase and fare the best under an airfare tax.[15]

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[10] Congressional Budget Office, January 1987, p. 12.
[11] Congressional Budget Office, January 1987, p. 18.
[12] Congressional Budget Office, January 1987, p. 18.
[13] Congressional Budget Office, January 1987, p. 23.
[14] Congressional Budget Office, January 1987, p. 28.

IV. The Socio-economic Status of Blacks in the United States

The impact of increased federal excise taxes on the poor, on blacks, and other minorities cannot be fully assessed unless an evaluative analysis is made of the socio-economic status of blacks in the United States.

In 1980, blacks made up 12.1 percent of the adult civilian labor force, 11.4 percent of those employed, and 22.4 percent of those unemployed. At that time, black adults experienced a rate of unemployment that doubled their percentage in the labor force and a rate of employment that was below their labor force share. Moreover, non-whites, in general, and blacks, in particular, are under-represented in the fastest growing high wage occupations such as computer specialists, engineers, accountants, managers, and administrators. Consequently, most blacks who work do so in jobs with low wages, with limited job security and advancement.

The employment outlook of black teenagers is even more critical and has been for approximately a decade. In 1980, the unemployment rate of black teenagers was 35.8 percent, while that of white teenagers was 15.5 percent. The rate of participation of black teenagers in the labor force is also much lower than those of white teenagers.

An analysis of current population reports by the Bureau of Census entitled "Money Income and Poverty Status of Families and Persons in the United States: 1985", throws further light on the socio-economic status of blacks and other minorities in the United States.

The estimated median income for white families in 1985 was $29,150 as compared to the Spanish speaking median family income of $19,030 and the median income of black families of $16,790. These data indicate that the income gap in 1985 between white, black and Hispanic incomes still remains wide.

This differential persists in real per capita income. Real per capita income in 1985 in the United States was $11,010 with the per capita income of whites estimated at $11,670 while that of blacks was $6,840 and persons of Spanish origin was estimated at $6,610.

Taking into consideration that the poverty threshold for a family of four in 1985 was $10,989, it is of significance that 33.1 million persons or 14 percent were found to be below the poverty level in 1985. More specifically, in 1985, 22.9 million whites or 11.4 percent were in poverty as contrasted with 8.9 million blacks or 31.3 percent, and 5.2 million Spanish origin persons of mixed racial origins or 29.0 percent.

Additionally, the poverty rate among children under 18 years old was 20.5 percent in 1985. The rate among black children was 43.4 percent and Spanish origin children, 39.9 percent.

It is of additional significance that the number of poor families in 1985 was 7.2 million and that almost one-half of these, 3.5 million, had a female head of household with no husband present. The poverty rate among families in this same year was 28.7 percent.

For the purpose of this study, it is important to note that regionally, the poverty rate is highest in the South with the implication that additional increases in federal excise taxes might conceivably have a more adverse effect on this region than any other region in the United States.

Numerically, therefore, there are predominantly more whites in poverty in the United States than there are blacks and other minorities. The proportion, however, of blacks and other minorities is greater than that of whites. All racial ethnic groups who are poor, therefore, will suffer with varying degrees of intensity if there are further increases in federal excise taxes.

Additional indicators of low income prevalence can be gleaned from the current minimum wage. In the United States, 6.7 million men and women earn the minimum wage of $3.35 an hour or less. Approximately 70 percent of those who are paid the minimum wage are women. An increasingly high proportion of these women are household heads who support families on these low wages. A significant proportion of these women are black.

It is significant that if one works 40 hours per week, a minimum wage worker will earn $6,968 annually. This is $400 below the poverty line for a worker with a single dependent and $1870 below the poverty line for a family of three. Therefore, the total number of workers who are living below the poverty level increased from 6.7 million in 1975 to 9.1 million in 1985.

The ranks of the low income are also augmented by the decreasing number of black farmers in the U.S. In 1920, there were 925,710 black farmers in the U.S. In 1982, however, there were fewer than 33,250 black farmers. Additionally, between 1978 and 1982, all farms in the U.S. declined less than one percent while black operated farms decreased by about 10 percent. Moreover, between 1980 and 1986, the number of FMHA ownership loans to all farmers in the United States declined by 68 percent, while the number of owernship loans to black farmers decreased by 91 percent.

V Options to Federal Excise Taxes

The above indicates that even modest increases in excise taxes will take more than all of the tax relief afforded by the 1986 tax reform bill, which gave tax payers with incomes of less than $19,000 an average tax reduction of $39. More specifically, revenue raising proposals in Congress to increase federal excise taxes could conceivably cost the poor five times as much -- nearly $2 billion -- as they would receive in income tax cuts from the 1986 Tax Reform Act. An increase in excise taxes would be in conflict with and counterproductive to the fairness achieved by the 1986 tax reform legislation. As a consequence, the tax will magnify, in geometric proportions, the plight of the poor, including a numerical majority of whites and a proportional majority of blacks and other minorities.

Federal Income Tax is considered to be the most progressive and the least regressive of all of the traditional revenue raising devices. The "sense" of Congress in drafting and approving the 1986 Tax Reform Act was that although Federal Income Tax was moved to a higher level of progressivity, there was still room for improvement.

The following options must, therefore, be seriously considered:

1. The Speaker of the U.S. House of Representatives, James Wright, is a staunch advocate of one such change as a revenue raising option. Speaker Wright advocates freezing the income tax rate for high income individuals in the top bracket at 38.5 percent, rather than allowing it to fall to 28 percent next year, as scheduled. This approach, if taken, can avert approximately $22 billion in 1988 tax cuts for the very wealthy -- more than the $19.3 billion in revenue now sought.

2. The top corporate rate should be cut to 38.5 percent rather than to 34 percent as proposed. This proposed 38.5 percent rate is substantially lower than the 46 percent rate applied to taxable income of $100,000 or more that was in effect until June 30. This rate would yield approximately $4 billion in 1988 and $14 billion in three years.

3. In 1988, the top estate tax rate is scheduled to be reduced from 55 percent to 50 percent. If this rate is frozen at 55 percent, revenue losses over the next five years of $2 billion will be avoided.

4. A loophole in the 1986 Tax Reform Bill allowed estates to escape taxation by selling stock to employee stock ownership plans. If this change is made, $5 billion in revenue can be raised over three years.

STATEMENT OF HON. JUDD A. GREGG, U.S. CONGRESSMAN FROM THE STATE OF NEW HAMPSHIRE

Congressman Gregg. Thank you, Mr. Chairman. I appreciate the opportunity to testify before the committee. I do represent New Hampshire, and I also have the good fortune to serve on the Ways and Means Committee in the House, your companion committee.

We had hearings on these issues over the last few weeks.

I wanted to bring to your attention one option which I think your committee might wish to consider. It is a new option. It is a manner under which you can raise a significant amount of revenue and also address one of our most acute health problems.

In the New England region and throughout the country, people are becoming aware of the very serious problem of acid rain. And the question over the last eight years, as we have debated the issue of acid rain, is whether or not we could pass regulatory language which would adequately reduce the rate of pollution caused by sulfur emissions and nitrogen emissions.

It has been fairly clear from the activities of the Congress that we have been unable to reach a concensus for a regulatory approach to bring under control the issue of acid rain.

Thus, I have introduced, along with Congressman Frenzel and Congressman Downey, a piece of legislation—and Congressman Jeffords, whom I think may be appearing here—which would attempt to address the acid rain issue in what I think is a much more efficient way, a much faster way, and in fact a more progressive way, doing it through the tax law.

This bill, which creates a tax called the SANE Tax, would tax on a progressive rate the amount of emissions generated by high sulfur emitting stationary source activities.

Senator Packwood. Could I ask just a quick question? Do you envision this tax as sort of a trust fund to take care of the acid rain expenses? Or is it to be used generally to make up a reconciliation deficit or other general fund purposes?

Congressman Gregg. Our bill is introduced, one, as a tax; and then we have a separate bill that creates a trust fund. It is our belief that the money should go into the trust fund, but the Congress would have the option not to do that; but we do feel that it is more logical to put it into the trust fund.

The rate of taxation would produce approximately $6 to $8 billion in the first year. Since the tax is meant to create action within the marketplace and thus have a response from those utilities which are creating the pollution, the rate of taxation—one would hope, anyway—would go down as the years go on because it would create a disincentive to pollute and create an incentive to retrofit the facilities that are causing the pollution.

The bill also proposes—the trust fund section of the bill—that companies would be able to receive tax-free loans which would be forgivable loans in order to retrofit their plants; and the rate of forgiveness would be tied to the speed at which the companies retrofit their plants.

In addition, the bill gives a 25 percent tax credit for those companies which purchase retrofitting material. The effect of this language overall, as I mentioned, is to draw a quick and hopefully effective response to the very significant environmental problem of acid rain, but at the same time create a significant amount of revenue for the Congress.

Thank you.

The CHAIRMAN. Thank you very much, Mr. Gregg.

[The prepared written statement of Congressman Gregg follows:]

STATEMENT OF THE HONORABLE JUDD GREGG

SECOND DISTRICT, NEW HAMPSHIRE

REGARDING

PROPOSALS TO TAX SULFUR DIOXIDE AND NITROGEN OXIDES

BEFORE

THE SENATE COMMITTEE ON FINANCE

HONORABLE LLOYD BENTSEN, CHAIRMAN

WEDNESDAY, JULY 15, 1987

Mr. Chairman and Members of the Committee, my name is Judd Gregg and I represent the people of New Hampshire's Second Congressional District in the House of Representatives. In that body, I have the good fortune of serving on this Committee's counterpart; namely, the House Committee on Ways and Means.

As you know, last week the Ways and Means Committee held similar hearings on proposals to raise revenue as called for in the recently adopted Budget Resolution for Fiscal Year 1988 and beyond. During these hearings, it struck me that the testimony resembled that which we all heard during the tax reform hearings of the 99th Congress.

At that time we heard the familiar refrain: I'm all for tax reform, BUT........ don't eliminate my deduction. Last week the Ways and Means Committee similarly heard: I'm all for deficit reduction, BUT........ don't increase my taxes. However, I come before you today to do the opposite -- to suggest a manner in which significant amounts of revenue can, and should, be raised.

On May 21st I, along with Tom Downey (D-NY), Bill Frenzel (R-MN) and Jim Jeffords (R-VT), introduced the Sulfur and Nitrogen Emissions (SANE) Tax Act of 1987. This legislation would impose an excise tax on emissions of sulfur dioxide and nitrogen oxides. The Joint Committee on Taxation included a "stripped down" version of the SANE legislation in its revenue raising options pamphlet, and it was estimated to raise roughly $6 billion per year. My own feeling is that this estimate was hurried and is quite low, but it is useful in demonstrating the powerful disincentive effect and revenue raising potential such an approach entails.

[Incidentally, Pete Stark (D-CA) more recently introduced legislation that would tax chloroflourocarbons, emissions of which have led to the dangerous depletion of our ozone layer. This bill was estimated to raise about $500 million per year, and is based upon the same basic concept -- taxing pollution.]

As might be obvious, I developed the SANE initiative with the primary purpose of combating the problems associated with "acid rain", the precursors of which are emissions of sulfur and nitrogen oxides. Studies show that a tax as proposed in my bill would result in sulfur dioxide emissions reductions comparable to the 10 million tons traditionally proposed in acid rain legislation.

I requested to speak to you because I feel the substantive and political benefits of such a pollution control mechanism should not be ignored. Although no companion legislation has been introduced in the Senate, this Committee should seriously consider the pollution tax concept in its upcoming deliberations.

I realize that such a tax departs from the traditional method of pollution control; that it is a fairly novel idea. But I am convinced it would work and achieve superior results. As such, I would like to briefly outline for you the rationale behind, and advantages of, the SANE approach, and to rebut some of the criticisms you may hear raised against it.

First, the basic theory behind such a tax is economic -- that by putting a price on pollution, less of it will occur as industry finds it more economical to reduce emissions than to pay the tax. Presently, industry pollutes free of charge, despite the fact that it imposes tremendous costs upon society -- it damages our environment, our basic structures and our own health. Imposing a tax begins to incorporate into the industrial process the costs of pollution, so that the final product reflects its true cost to society at large.

Second, because this approach is fundamentally economic, not regulatory, pollution control is dictated by free market forces, not bureaucracies. Polluters are not told when to reduce, by how much, and what technology to use. Rather, they are allowed to make these decisions based upon their own individual situation. As such, as a June 1986 study by the Congressional Budget Office confirmed, pollution reduction would occur more swiftly, more efficiently and in a more cost-effective manner. This not only benefits the environment, but the consumers and the nation at large -- particularly those in areas of the country which stand to bear the largest burdens of any such pollution control program.

Third, I firmly believe that an economic mechanism offers us more certainty. For years, the traditional method of pollution control has been to impose standards and deadlines upon industry through the regulatory process. Such statutory standards were meant to ensure at least a minimum level of pollution control. Yet, we all know that these standards and deadlines continually go unheeded or are postponed (local sewage treatment plants, for example).

Further, with regard to acid rain in the 100th Congress, the main hope for efforts to strengthen existing regulatory standards rests on the fact that there is a political need to postpone or alleviate regulatory standards established with respect to ambient levels of ozone pollution -- which provides the legislative vehicle. Quite ironically, we are asked to place our faith in new regulations as we simultaneously alter the old ones.

Nevertheless, you will hear that a tax would be an inappropriate way to deal with pollution control. Yet, it has been successfully utilized around the world and, as I have tried to explain, it would be more appropriate. In other words, such arguments come from polluters who know it would work.

You will hear that such a tax would be hard to administer. Yet, regulatory controls are extremely complex and, according to the Congressional Budget Office, the administrative burdens of such a tax would be small compared to revenues collected. My own proposal would require continuous emissions monitoring, which would be quite simple and very accurate, but other methods of measuring pollution are already in existence and required of industry.

You will hear that such a tax would discourage the use of high sulfur coal. Yet, this argument has been used against every acid rain bill, and the efficiencies gained from a market-oriented approach would significantly lessen such impacts. Further, additional credits or deductions could easily be built into the tax structure so that the coal market equilibrium, and existing jobs, would be better maintained.

You will hear that such a tax would undermine our "competitiveness", and that domestic energy costs would increase. Yet, you will hear the competitiveness argument used against almost every tax you consider. In reality, as the tax encourages energy conservation and efficiency, our energy position would be enhanced.

Furthermore, as mentioned, at its most basic level the tax is meant to incorporate into the industrial process the costs of pollution to society, and these costs are tremendous, indeed. Testimony before the Ways and Means Committee last week pointed out that the American Lung Association (ALA) has found sulfur pollution to be the third largest cause of lung disease, after passive and active cigarette smoking, and that it causes up to 50,000 premature deaths each year in the Northeast. Although it is impossible to price human life, the ALA estimates the medical costs to be $40 billion per year. The National Academy of Sciences estimates that resource damage from these pollutants to be $7 billion per year -- an estimate that is surely quite low, but still larger than the amount that would be raised by my legislation.

These numbers are large and frightening, but the point is not to scare you. Rather, I would like to impress upon you that reducing pollution will surely alleviate these costs, and help remove what is now a tremendous drag on our economy -- and our competitiveness. The Business Roundtable has estimated that the pollution reductions which have occurred due to the Clean Air Act have saved our economy $4.4 billion per year. Unfortunately, however, emission trends are now leveling off and will soon again increase. Thus, when you hear the competitiveness argument, I would urge you to consider the source, think big picture, and realize that, in fact, the opposite is true.

Mr. Chairman, again, I did not come here to get into an acid rain debate. I simply wanted to raise this issue, discuss the advantages of an economic method of pollution control, and commend the concept to your Committee for consideration.

If you would like to see what such a tax would look like in more detail than what is contained in the Joint Committee's pamphlet, my legislation is numbered H.R. 2497 and H.R. 2498. Or, please get in touch personally, as I'd be glad to send you a copy and/or discuss it further.

Thank you for the opportunity to testify. I will be happy to answer any questions you may have.

The CHAIRMAN. The sequence of arrival of the Senators this morning is Chafee, Roth, Baucus, Packwood, Durenberger, and Heinz.

Senator HEINZ. Mr. Chairman, I don't want to impose on anyone's time, but I just wanted to say that I am going to have to go to the floor—as we soon all will—to vote.

The CHAIRMAN. Yes, of course.

Senator HEINZ. But I anticipate the banking portions of the bill will be up, and I will be probably not be back to the hearing. I want to apologize to our witnesses and to you, Mr. Chairman.

The CHAIRMAN. We understand the competition we have for the attention of the members. Senator Packwood?

Senator PACKWOOD. I have already asked my question, Mr. Chairman.

The CHAIRMAN. I have no further questions. We appreciate very much your testimony. We thank these witnesses.

Our next witness will be Mr. Dennis Ross, Tax Legislative Counsel at the United States Treasury Department. Mr. Ross, we are pleased to have you with us this morning. We do have a vote on the floor of the Senate; and obviously, you can see some of the members leaving for that vote. And I will have to leave in a moment also, but I think Senator Baucus is returning to chair the committee. We will let you get underway, but I may have to interrupt as the vote progresses a bit further.

STATEMENT OF DENNIS ROSS, TAX LEGISLATIVE COUNSEL, U.S. TREASURY DEPARTMENT, WASHINGTON, DC

Mr. ROSS. Thank you, Mr. Chairman. In fact, I have a very brief oral statement, so no interruption may be necessary. I have a more detailed written statement, which I would request be placed in the record.

The CHAIRMAN. It will be placed in the record.

Mr. ROSS. Thank you, Mr. Chairman. It should come as no surprise to the members of this committee that the President remains firm in his opposition to new taxes. Thus, the President has made clear his opposition to the budget reconciliation resolution and its inclusion of substantial tax increases over the next three fiscal years.

The President's opposition represents his firm belief that the American people and the American economy are not undertaxed and that the solution to the problem of the deficit lies in restraining Government spending and the overall size of the Government.

The CHAIRMAN. Mr. Ross, because I am going to have to leave, I am going to interrupt you to ask a question. Now, you state the President's opposition to any new taxes, yet isn't it correct that that the President's budget had some $6 billion that would be considered new taxes? And isn't it just a question of a difference in amounts we are talking about?

You did have in that budget some $6 billion that I think would be termed taxes.

Mr. ROSS. Mr. Chairman, there is in fact a figure of total revenue initiatives in the President's budget that is somewhat in excess of that.

The CHAIRMAN. So, isn't our argument really over the amount?

Mr. ROSS. No——

The CHAIRMAN. If the budget already has new taxes, hasn't he already taken that kind of a stand?

Mr. ROSS. Mr. Chairman, no, we would not view the amounts as new taxes.

The CHAIRMAN. I beg your pardon?

Mr. ROSS. We would not view the revenue increases—there are revenue increases in the President's budget; no one has ever contested that. We would not characterize them as tax increases.

They are generally in the nature of initiatives that would increase——

The CHAIRMAN. Generally, in the sale of assets, in user fees—those types of things—but as I understand it from a study that we have seen, $6 billion of it has to be considered pure taxes.

Mr. ROSS. I would have to disagree with you on that point, Mr. Chairman. The $6.1 billion comes essentially from either user fees; to some extent it is also from improved collection of existing taxes—tax liabilities already in place, taxes already——

The CHAIRMAN. You don't see a user fee as a tax?

Mr. ROSS. Well, I think it might be labeled a tax, but there clearly is a difference——

The CHAIRMAN. You think it is better to label it a Government receipt?

Mr. ROSS. If it is a tax, and I think the terminology is not especially important, but if it is a tax——

The CHAIRMAN. Oh, it appears to be in Washington. I have always been impressed by the imaginative terms used in expressing what a tax is. Before I came here, I thought of it as a tax, but I now find it is revenue enhancement and it is Government receipts, and it is all kinds of good things.

Mr. ROSS. If taxes are understood as anything that involves the collection of revenues by the Government, perhaps the term would extend to some of the items in the President's budget. It is quite clear, however, that they are very different in kind, than general taxes such as collected through the income tax system.

Again, the revenues generated are attributable to existing taxes already owed and to certain newly imposed user fees, which are charges really for specific services, and I think different in principle than a general tax.

The CHAIRMAN. Does that mean that the President would be for a gasoline tax, because it is for a specific purpose, for building highways and bridges——

Mr. ROSS. The gasoline tax, as you know, is a dedicated source of revenues. And as I understand proposals to increase gasoline excise taxes, they do not involve dedication of those amounts to the highway trust fund, nor do we envision a need for substantial increases in the revenues going to the highway trust fund.

If someone were to put forward a proposal of that kind, perhaps that is something the Administration would look at. I don't really know, but I don't think we have seen a proposal like that.

Just to continue with my statement, Mr. Chairman, in addition to——

The CHAIRMAN. Mr. Ross, I see the vote is more than halfway over, and I am going to have to put this in recess for not more than five minutes, I think. I think Senator Baucus will be returning; and I apologize to you.

[Whereupon, at 10:40 a.m., a brief recess was held.]

AFTER RECESS

Senator BAUCUS. The committee will resume. Mr. Ross, I understand you were testifying, and you were also involved in a colloquy with the chairman. Why don't you complete your testimony; and at the conclusion of your testimony, I will have some questions. And by that time, other members of the committee may also have returned.

Mr. ROSS. Fine, thank you. Again, I do have only a very brief statement, and let me simply return to it.

Mr. Chairman, the President's opposition to new taxes represents his firm belief that the American people and the American economy are not undertaxed. Moreover, we believe it is extremely important that we not undo the significant tax reform changes accomplished less than a year ago.

Any increase in taxes should be viewed as a breach of the pact made with the American people, that revenues increased from various base-broadening provisions would be returned to them in the form of lower rates.

With these considerations in mind, the President's budget for fiscal year 1988 did propose various revenue initiatives that involved the collection of taxes owed but not paid, reform of certain trust funds under existing law, and finally reasonable user fees for Federal programs that deliver services to identifiable beneficiaries.

None of these revenue initiatives constitutes a general tax increase for the American taxpayer. Rather, the proposals represent a strengthening of our present system and the elimination of certain unwarranted exceptions that exist in the current law.

Mr. Chairman, my written statement contains very detailed discussion, justification, and explanation of each of these proposals.

That statement is really no different than the testimony that was delivered before this committee last February by Assistant Secretary Mentz.

I would not at this time, unless requested to do so, engage in any further detailed discussion of those proposals although, of course, I would be happy to respond to your questions.

I would note that the Administration continues to support each of those proposals.

Allow me, however, to briefly discuss the possibility—as some have proposed—to raise revenues through a reduction of the tax rate on capital gains. As you will recall, the Administration supported a reduction in the capital gain rate to 17.5 percent as part of the President's tax reform proposal submitted to Congress in May of 1985.

Although the increase in rate for capital gain to 28 percent under the Tax Reform Act was not something advocated by the Administration, and indeed, the Administration was disappointed in this result, we strongly support the Tax Reform Act of 1986 and would not like to see it reopened through modifications of the tax rate structure.

With regard, however, to the revenue effects of a reduction in the tax rates on capital gains, we understand that to maintain consistency with CBO's scoring for tax reform, the congressional budget estimating process would attribute a revenue loss to a proposal for a substantial reduction in the rate of tax on capital gains.

There is, however, a body of researchers suggesting that a substantial reduction in the maximum capital gain rate could result in increased revenues over time.

I would note moreover that Treasury has itself issued a report to Congress entitled "Report to the Congress on the Capital Gains Tax Reductions of 1978," which concluded that the reduction in the capital gains rate that was adopted in 1978 may well have resulted in a significant net increase of revenues.

I should, however, note also that Treasury has not prepared an estimate of the revenue effects of a reduction in the maximum rate of tax on capital gains in the context of the Tax Reform Act of 1986, which of course made many changes in the law, some of which could affect the analysis of the effect of such a proposal.

Mr. Chairman, that concludes my prepared remarks. I would again be pleased to respond to any questions.

[The prepared written statement of Mr. Ross follows:]

Release Upon Delivery
Expected at 10:00 a.m.,
July 15, 1987

STATEMENT OF
DENNIS E. ROSS
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am here today at your request to reiterate the Administration's support for certain revenue initiatives included in the President's fiscal year 1988 budget proposal. The Administration continues to support the $6.1 billion of additional governmental receipts shown in the President's budget proposal. The President has made clear his opposition to H. Con. Res. 93, the budget reconciliation resolution, and its inclusion of substantial tax increases over the next three fiscal years. As a representative of the Administration, my testimony, of course, will be consistent with this position. Accordingly, I will confine my remarks to the revenue initiatives included in the President's fiscal year 1988 budget proposal.

The Administration believes that it is extremely important that we not undo any of the dramatic and important tax reforms that were accomplished last year. Any increase in taxes should be viewed as a breach of the pact reached last year to return, in the form of dramatically lower tax rates, any increase in revenue that would otherwise accrue from making the tax base broader and more fair.

With this in mind, the Administration's Budget for Fiscal Year 1988 proposed various revenue initiatives that involve:

- collection of taxes owed but not paid;
- reform of certain trust funds; and
- reasonable user fees for Federal programs that deliver services to identifiable beneficiaries.

None of these revenue initiatives constitutes a general tax increase for the American taxpayer. Rather, the proposals represent a strengthening of our present system and the elimination of certain unwarranted exceptions under current law.

On February 4 of this year, Assistant Secretary of the Treasury for Tax Policy J. Roger Mentz had the opportunity to appear before this Committee to discuss each of the proposed revenue initiatives. In this statement, I will reiterate the Administration's rationale for each of the revenue initiatives, which we continue to support within the framework of the Administration's fiscal year 1988 budget proposal.

Before turning to the proposals in the President's budget, allow me to discuss briefly the possibility, as some have proposed, to raise revenue through a reduction of the tax rate on capital gain. As you will recall, the Administration supported a reduction in the capital gain rate to 17.5 percent as an important feature of the capital recovery provisions of the President's tax proposals issued in May 1985. Although the increase in rate for capital gain to 28 percent was not advocated by the Administration, and we were disappointed in this result, we nevertheless strongly support the Tax Reform Act of 1986 and do not believe it should be reopened by modifying the tax rate structure.

With regard to the revenue effects of a reduction in tax rates on capital gain, we understand that to maintain consistency with CBO scoring for tax reform, the Congress' budget estimating process would attribute a revenue loss to such a proposal. There is, however, a body of research suggesting that a substantial reduction in the maximum capital gain rate could result in increased revenue over time. Moreover, Treasury has issued a Report to the Congress on the Capital Gains Tax Reductions of 1978, which concludes that the 1978 reduction in capital gain rates may have resulted in a significant increase in revenues.

Treasury has not, however, prepared an estimate of the revenue effects of a substantial reduction in the capital gain rate in the context of the Tax Reform Act of 1986, with its myriad changes in the tax law. One of the changes made in the Tax Reform Act, the increase in capital gain rates beginning in 1987, caused many investors to realize capital gains at the end of 1986. This may have diminished the stock of accrued capital gains that would be realized in the short run in response to a lower rate.

Extend Medicare Hospital Insurance Coverage to all State and Local Government Employees

Background

State and local government employees who began work after March 31, 1986 are covered by Medicare Hospital Insurance, and a tax is imposed on both the employee and the employer to pay for this benefit. The rate of tax for 1987 is 2.9 percent of the employee's wages (up to $43,800), paid half by the employer and half by the employee. An employment tax for medicare is not imposed, however, on the wages of State and local government employees who were hired before April 1, 1986.[1] Nonetheless, roughly 75 percent of such employees receive Medicare coverage because of eligibility through a spouse or because of a prior period of work in covered employment. Medicare coverage is mandatory for Federal employees, regardless of when hired.

Proposal

The Administration proposes to extend Medicare coverage to State and local government workers hired before April 1, 1986.

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[1] States and localities are authorized to extend Medicare coverage to employees hired before April 1, 1986, if they enter into a voluntary agreement with the Department of Health and Human Services.

Discussion

Extension of Medicare coverage to State and local government employees hired before April 1, 1986, who are the only major group of employees in the United States not participating fully in Medicare, would ensure that the 25 percent of such employees who are not currently covered receive the benefits of Medicare. Such a change also would eliminate the charge to the Medicare trust fund caused by the fact that most State and local employees, even though they are not subject to the payroll tax, are nevertheless covered by Medicare.

Revenue Impact

We estimate that this change in Medicare coverage, proposed to be effective January 1, 1988, will increase receipts by $1.6 billion in the 1988 fiscal year.

Expand Employer's Share of Social Security Taxes to Include All Cash Tips

Background

Under Chapter 21 of the Internal Revenue Code of 1986 (the "Code"), relating to Federal Insurance Contribution Act ("FICA") taxes used to fund the Social Security system, a tax is imposed on the employee and the employer, based on the wages paid to the employee. In general, the tax imposed on the employee and the employer is equal. The employer is responsible for withholding the employee's share of the tax from the employee's wages and remitting the tax, together with the employer's share of the tax, to the Internal Revenue Service. The current tax rate for both the employer and the employee is 7.15 percent of wages, consisting of 5.7 percent for Old-Age, Survivors and Disability Insurance and 1.45 percent for Medicare Hospital Insurance.

Section 3121(q) of the Code provides that for purposes of chapter 21 of the Code, other than the tax imposed on employers, tips received by employees are considered remuneration for services and are subject to the FICA tax imposed on employees. The tips are generally deemed to be received at the time the employee files a written statement with the employer reporting the receipt of the tips, as is required under section 6053 of the Code.

The full amount of tips received by an employee is not, however, usually subject to the FICA tax imposed on the employer. Under section 3121(t) of the Code, if an employer pays an employee wages that are below the Federal minimum wage, and the employee also receives tips in the course of his or her employment, the employee is deemed to receive wages equal to the Federal minimum wage for purposes of the employer's share of FICA taxes. Any tips received in excess of the difference between the wages paid and the minimum wage, however, are not subject to the employer's portion of the tax.

To illustrate the effect of this rule, assume that an employee earns $6.25 an hour as a waiter, consisting of $2.25 an hour in wages and $4.00 an hour in tips. The employee is required to pay social security tax on the full $6.25 an hour, subject to the applicable wage base limitation. The employer is only required to pay the tax on the Federal minimum wage, currently $3.35 an hour, rather than the full $6.25 an hour.

Proposal

The Administration proposes that all cash tips be included within the definition of wages for purposes of the employer's share of FICA taxes. Thus, employers would be required to pay FICA taxes on the total amount of cash tips (but, obviously, not in excess of the Social Security wage base).

Discussion

Requiring the employer to pay FICA taxes on the same amount of wages as does the employee--salary plus tips--follows the general structure of Chapter 21 that requires an equal tax to be paid by both parties. This proposal would thus eliminate the advantage currently enjoyed by some employers (those whose employees receive a portion of their wages by means of tips) and not by other employers.

In addition, employees under present law earn Social Security credit for the full amount of tips received, while the employer's share of FICA taxes is usually based on a smaller amount. In effect, the Social Security trust fund is subsidizing the employer to the extent of the employer's share of FICA taxes on any tips received by an employee in excess of the difference between the employee's wages and the Federal minimum wage. The fact that the employer does not directly pay the tips to the employee should not excuse the employer from payment of its share of FICA taxes. In substance, tips received by employees are the economic equivalent of wages and should be taxed in the same manner.

Present law regarding tips also creates an administrative burden for the Social Security Administration ("SSA") because separate records must be kept of the amount of reported tips for tax accountability purposes. Each year the U.S. Treasury transfers to the Social Security trust fund the amount of FICA taxes due on the total wages reported to the SSA during the prior year. Because no FICA taxes are paid by the employer on tips (other than the amount necessary to bring the employee's salary up to the minimum wage), the SSA must keep a separate record of tips so that it will be able to report to the Treasury Department with respect to the total amount of wages on which both employer and employee taxes are due and the total amount on which only employee taxes are due.

Revenue Impact

We estimate that the inclusion of the full amount of cash tips in the definition of wages for all purposes, proposed to be effective January 1, 1988, will increase receipts in the 1988 fiscal year by $0.2 billion.

Extend Social Security Coverage to the Inactive Duty Earnings of Armed Forces Reservists and to Earnings of Certain Students, Agricultural Workers, Individuals Aged 18-21 Who Work for their Parents, and Individuals Who Work for their Spouses

Background

Social Security taxes are imposed on the "wages" of an employee received as remuneration for "employment," both terms being defined in section 3121 of the Code. An employee only receives Social Security credit for his earnings if his salary constitutes wages under section 3121 and if his job is included in the definition of employment ("covered employment").

Armed Forces Reservists. Approximately 1.4 million Armed Forces reservists do not receive Social Security credit and are not subject to Social Security taxes for their inactive duty earnings, because "inactive duty training" (generally, weekend training drill sessions) has not been included as covered employment under section 3121. Earnings from full time active duty or from "active duty for training" (training sessions lasting several weeks) constitute covered employment under current law.

Students. Services performed by a student under various circumstances in an academic setting are excluded from coverage under Social Security and the student's wages are not subject to FICA taxes. Such students include those employed by a school they are attending (or college club or an auxiliary nonprofit organization of a school) and student nurses employed by a hospital or nurses' training school they are attending.

Agricultural Workers. Under present law, cash remuneration paid to an employee in any taxable year for agricultural labor is excluded from the definition of wages unless the employee receives more than $150 during the year for such labor or the employee works for the employer more than 20 days during the year.

Individuals Aged 18-21. Services performed by individuals under age 21 who are employed by their parents, even if employed in the parents' trade or business, do not currently constitute covered employment.

Spouses. Services performed by an individual in the employ of his or her spouse do not constitute covered employment.

Proposal

The Administration proposes to include services performed by reservists in "inactive duty training," by students employed by their educational institution, by individuals aged 18-21 working for their parents in a trade or business and by individuals working for their spouses in a trade or business, in the definition of covered employment. The Administration also proposes, with respect to agricultural labor, that: (a) any remuneration for agricultural labor paid by an employer to an employee constitute wages if the employer pays more than $2,500 to all employees for such labor during the taxable year, (b) the $150 annual cash pay test continue to be applied if the $2,500 annual payroll test is not met, and (c) the 20-day test be eliminated.

Discussion

Armed Forces Reservists. The proposal to include inactive duty training, commonly called monthly drill training, within the definition of covered employment would improve social security protection for reservists. Such training was not originally included in the definition of covered employment for two reasons:

(1) because most reservists were covered under Social Security through their regular work, coverage of monthly drill training, which involved very small amounts of pay, would have resulted in little additional Social Security protection for reservists; and (2) reporting pay for monthly drill training would have imposed an undue administrative burden on reserve units.

These reasons for not covering inactive duty training are no longer compelling. The pay for monthly drill training is now substantial. Such drill pay accounts for approximately 70 percent of a reservist's annual reserve earnings. Generally, a reservist is required to train at least one weekend monthly. Drill pay ranges from approximately $1,000 to $3,800 a year for enlisted members and from $1,700 to $9,000 for officers.

The proposal would not create an administrative burden for reserve units, because they now withhold Federal income taxes from wages paid to reservists for all services, including inactive duty training. Indeed, because reservists' pay would be treated the same for Social Security and Federal income tax purposes, the proposal would reduce reporting complexities.

Students. The reason for excluding certain student services from the definition of covered employment was that the small amount of protection students would gain would not be proportionate to the wage reporting and tax payment burden imposed on their employers. However, because in most instances the employer is now required to withhold income taxes from such earnings and because payroll practices have become more sophisticated, the administrative burden placed on employers by the proposal is not unreasonable.

Furthermore, students employed by their educational institutions need the protection of the Social Security program as much as other workers. Because of this exclusion, students may not gain any Social Security protection or may have gaps in their protection. This is important because features have been added to Social Security that are particularly desirable for younger workers (e.g., disability benefits and Medicare for the disabled). Finally, changes in the student population itself have increased the students' need for protection--students today are older, stay in school longer and are more likely to be married and have children.

Agricultural Workers. The proposal to adopt an annual $2,500 threshold test for agricultural employers would result in the coverage of more than 95 percent of the remuneration paid to all farm workers and would improve the Social Security protection afforded to about three-quarters of a million farm workers and their dependents. The proposal will not unreasonably increase the recordkeeping burden of farm employers. In particular, farms with expenditures in excess of $2,500 for farm wages will in all likelihood already report wages for Social Security purposes for at least some employees who meet the coverage test under current law. These employees will thus already be familiar with Social Security tax recordkeeping. The 20-day test would be eliminated under the proposal because, due to increased wage levels for farm work, employees will normally meet the $150 test well before working for 20 days.

Individuals Aged 18-21. Individuals between the ages of 18 and 21 who are employed by their parents cannot acquire the Social Security coverage which is available to other employees of the same age who perform the same or similar services for employers other than their parents. Changing the law to provide coverage for an individual aged 18 or older employed in his or her parents' business also would eliminate a potential tax avoidance device whereby self-employed persons may be able to use the present coverage exclusion to reduce their own Social Security taxes. Under present law, the self-employed person can take the position that paying a child under age 21 a large salary, which is not subject to the Social Security tax, and claiming the salary as a business deduction, will thereby reduce the amount of the parent's income that is subject to the Social Security self-employment tax.

Spouses. Under current law, an employee spouse is not covered under Social Security in the same manner as other employees. The employee spouse, even one who has some prior earnings from covered employment, may not have disability protection and will have reduced retirement protection. More significantly, in cases where the employee spouse had no prior earnings from covered work, the employee spouse will have no Social Security protection in his or her own right. Accordingly, if the spouses were to divorce within ten years of marriage, the employee spouse would lose eligibility for Social Security auxiliary or survivor benefits and would have no protection despite years of employment. The Administration's proposal would provide a married person who is actually performing services and being paid wages as an employee of his spouse with protection under the Social Security system.

The exclusion for an employed spouse also lends itself to a tax avoidance device, similar to that described above for children, under which a married couple working together in a business may attempt to reduce their Social Security tax liability by paying a large salary to the employed spouse, thereby lowering the amount of self-employment income taxable and creditable to the other spouse. The proposal to repeal the exclusion for such wages removes this potential artificially to lower FICA tax payments when a couple operates a business together.

Revenue Impact

The changes in Social Security coverage described above, proposed to be effective January 1, 1988, are estimated to increase receipts by $0.2 billion in fiscal year 1988.

Treat Employer-Provided Group-Term Life Insurance as Wages for Purposes of Social Security Taxes

Background

The value of group-term life insurance coverage provided to an employee is excluded from the definition of "wages" in section 3121 of the Code. For income tax purposes, however, the value of such insurance, other than the cost of the first $50,000 of coverage provided to an employee, is included in taxable income. Moreover, if the insurance coverage is provided to employees in a manner that discriminates in favor of key employees, then the entire cost of the coverage is included in taxable income of the key employees.

Proposal

The Administration proposes to conform the treatment of group-term life insurance for Social Security tax purposes to its treatment under the income tax. Accordingly, the cost of group-term life insurance would be included in the definition of wages for purposes of FICA taxes if the cost were taxable to the employee.

Discussion

The proposal would treat the provision of group-term life insurance the same for both FICA and income tax purposes. There is no Social Security program rationale for the unlimited exclusion of this employee fringe benefit. The FICA tax status of certain other fringe benefits, such as group legal services, meals and lodging, educational assistance, and dependent care assistance, has similarly been tied to the income tax status of such benefits.

Revenue Impact

We estimate that the inclusion of certain group-term life insurance in the definition of wages, proposed to be effective January 1, 1988, will increase revenue by $43 million in fiscal year 1988.

Repeal Certain Exemptions from Gasoline and Other Highway Excise Taxes

Background

The Highway Trust Fund, which is used to finance Federal assistance for highways and for mass transit systems, is funded by highway user fees, including excise taxes on gasoline, diesel fuel and tires, a sales tax on heavy trucks and trailers, and a heavy truck highway use tax.

Although the Highway Trust Fund is intended to be funded by all who use the nation's highways, there are several exceptions to this general rule. In particular, gasohol and certain other alcohol fuels, as described below, are partially exempt from the excise taxes on gasoline and diesel fuel. State and local governments are fully exempt from all Federal highway excise taxes. Public bus operators are fully exempted from Federal gasoline, diesel fuel, and other highway excise taxes. Private bus operators are fully exempt from the excise tax on tires and are partially or fully exempt from certain other excise taxes.

Proposal

The Administration proposes to repeal the exemptions from the highway excise taxes described above.

Discussion

Alcohol Fuels. Under current law, the general tax rate is 15 cents per gallon for diesel fuel and 9 cents per gallon for gasoline and special motor fuels. An exemption of 6 cents per gallon is provided for gasohol and certain alcohol fuels (neat methanol and ethanol fuels that contain 85 percent or more alcohol) produced from a substance other than petroleum or natural gas, and an exemption of 4 1/2 cents per gallon is available for such alcohol fuels produced from natural gas. The exemption of gasohol and alcohol fuels from the excise taxes for highway use distorts the allocation of resources. It also encourages users to purchase fuels that have a higher economic cost than alternative fuels because the tax system lowers the cost of the subsidized fuel. Moreover, the exemptions allow users of the highways to escape paying their fair share of the applicable use taxes. Accordingly, the Administration proposes to repeal these excise tax exemptions. (The Administration does not propose that the alcohol fuel tax credit, described in section 40 of the Code, be repealed).

Bus Operators, State and Local Governments. Highway trust fund taxes are designed to charge users of the public highways for the wear and tear they cause and for the Federally funded highway improvements made for their benefit. The exemptions for bus operators and for state and local governments are inconsistent with having all highway users paying their fair share of the cost of maintaining and improving our highway system.

Revenue Impact

We estimate that the repeal of these special exemptions, proposed to be effective October 1, 1987, will increase receipts by $0.6 billion in fiscal year 1988.

Increase Excise Tax on Coal Production; Treat Black Lung Income Replacement Benefits as Taxable Income

Background

The Black Lung Disability Trust Fund, which provides benefits to individuals (and their survivors) disabled by pneumoneucleosis (black lung disease), is funded in part by an excise tax on the sale of coal by producers. The current rate of tax is $1.10 per ton for coal from underground mines and $.55 per ton for coal from surface mines, with a cap of 4.4 percent of the sales price for each ton of coal produced. The Trust Fund is presently $2.9 billion in debt, even though the Federal government has assumed responsibility through the General Fund for paying $1 billion a year in income replacement benefits for some miners whose benefits are distributed by the Social Security Administration from general revenues. Moreover, the General Fund is currently bearing the interest costs on the amounts the Trust Fund has borrowed.

Under section 104(a)(1) of the Code, black lung replacement income benefits are excluded from taxable income.

Proposal

The Administration proposes to increase the excise tax on the sale of coal by producers to $1.70 per ton for coal from underground mines and $.85 per ton for coal from surface mines, subject to a cap of 6.8 percent of the sales price. This rate would apply through 1990, with decreasing rates thereafter. The Administration also proposes to repeal the requirement that the General Fund bear the interest costs incurred by the Trust Fund, and proposes that black lung replacement income benefits be included in taxable income.

Discussion

The excise tax proposed by the Administration is necessary to reduce and eventually to eliminate the deficit in the Trust Fund. The Administration's 1988 budget proposes certain changes to slow the growth of black lung benefit payments, including a one-year freeze on cost-of-living adjustments for benefits. Because benefit changes alone will not permit retirement of the Trust Fund's indebtedness, however, the excise tax on coal must be increased to restore the Trust Fund to solvency.

The exclusion of black lung income replacement benefits from taxable income is inappropriate because it allows income that is merely replacing taxable income to escape tax.

Revenue Impact

The increased tax on coal production and sale, proposed to be effective October 1, 1987, will increase fiscal year 1988 receipts by $0.3 billion. The inclusion of black lung replacement income benefits in income, proposed to be effective January 1, 1988, will increase fiscal year 1988 receipts by $21 million.

Increase Contributions to the Rail Industry Pension Fund; Extend Federal Unemployment Tax to Railroad Employment

Background

The rail industry pension fund is financed primarily by payroll taxes imposed on covered employers and their employees. Under present law, both the employer and the employee pay a "Tier I" tax that is equivalent to the Social Security taxes. In addition, a "Tier II" tax is paid by both the employer and the employee. The current rate of the Tier II tax is 14.75 percent for employers and 4.25 percent for employees, computed on the first $32,700 of the employee's salary.

Railroad employment is not presently covered by the Federal-State unemployment insurance system. Railroad employees are covered by a separate Railroad Sickness and Unemployment Fund, which is financed by payroll taxes levied on rail employers. The Fund has been insolvent for 22 of the last 27 years. It currently owes approximately $800 million to the rail pension fund.

Proposal

The Administration proposes to increase railroad retirement Tier II taxes by a total of 1.5 percentage points effective January 1, 1988, and by an additional 1.5 percentage points effective January 1, 1989. This increase will be shared by the employer and the employee. Railroad workers would become covered under the Federal-State unemployment insurance system beginning with transitional coverage on October 1, 1987. Railroads would begin paying taxes under the Federal Unemployment Tax Act effective January 1, 1988.

Discussion

Financing legislation for the rail industry pension fund enacted in 1974, 1981, and 1983 was based on certain assumptions as to the level of railroad employment and the level of pension contributions necessary to keep the Fund solvent. Those assumptions have proven to be incorrect and an increase in rail pension contributions, as recommended by rail pension actuaries, is needed in order to ensure the solvency of the Fund. Bringing rail employees within the Federal-State unemployment insurance system would result in these employees receiving the same unemployment insurance benefits as do other employees. This proposal would repay the $800 million debt to the rail pension fund.

Revenue Impact

We estimate that the additional pension fund contributions, proposed to be effective January 1, 1988, and again on January 1, 1989, will increase receipts by $0.1 billion in fiscal year 1988 and $0.3 billion in fiscal year 1989. We estimate that coverage of rail employees under the Federal-State unemployment insurance system, beginning with transitional coverage on October 1, 1987, will increase receipts by $0.1 billion in fiscal year 1988.

Repeal the Windfall Profit Tax

Background

Under current law, an excise tax is imposed on domestically produced crude oil. Taxable crude oil is classified in three tiers. Generally, oil in tier one is "old" oil that had been subject to price controls; oil in tier two consists of oil produced by a stripper well, plus petroleum reserve oil; and oil in tier three is newly discovered oil, tertiary oil and heavy oil. The base for the tax is the difference between a statutory base price (lower for tier one oil and progressively higher for tiers two and three), adjusted for inflation, and the amount for which oil is sold, less a severance tax adjustment. The tax rate is 70 percent for tier one oil, 60 percent for tier two oil, and 30 percent for tertiary oil and heavy oil. The tax rate for newly discovered oil is 22-1/2 percent through 1987, 20 percent for 1988 and 15 percent for 1989 and thereafter. Independent oil producers are taxed at a 50 percent rate for tier one oil with respect to 1,000 barrels per day of production and are exempt from the windfall profit tax on stripper well oil.

The windfall profit tax is scheduled to phase out over a 33-month period beginning in January 1991, or the first month after December 1987 in which cumulative net receipts exceed $227.3 billion, whichever date occurs first.

Proposal

The Administration proposes to repeal the windfall profit tax.

Discussion

The windfall profit tax was enacted in 1980 when a dramatic increase in the price of domestic crude oil was expected due to the decontrol of that price. Although the price of domestic oil did initially reach record highs, in recent months the price of oil has dropped so much that it is now below its pre-decontrol level (when adjusted for inflation). Consequently, little or no windfall profit tax is being collected, and the tax itself is, therefore, no longer appropriate. Even if crude oil prices again rise to levels that would generate significant profits for domestic oil producers, such profits would, in no way, be considered "windfall" profits. This is because a return to a profitable situation for domestic oil producers would be the result solely of market conditions (here and abroad) and not the result of the government lifting an artificial price barrier, as was the case when the tax was first imposed.

In general, the Tax Reform Act of 1986 was designed to produce uniform rates of taxation on the income generated in different activities, and to eliminate tax-induced distortions in investment. Repeal of the windfall profit tax is consistent with that objective.

Revenue Impact

Under the Administration's current oil price projections, the repeal of the Windfall Profit Tax would not have any revenue impact in 1988, or at any time prior to 1991.

Revise Customs Users Fee

Background

In 1986, Congress enacted an ad valorem user's fee on imports. The rate of the fee is 0.22 percent of value in 1987, dropping to 0.17 percent in 1988. For 1989, the Secretary of the Treasury is authorized to reduce the fee so that the amount realized is equal to the amount necessary for salaries and expenses for the commercial operations of the Customs Service.

The fee is scheduled to expire on September 30, 1989. The reason for enacting this fee was to ensure that the costs of services provided by the U.S. Customs Service are borne by the users of those services and not by the general taxpayer. Accordingly, the proceeds of the fee are deposited into a dedicated Customs Service account and are available, subject to appropriations, exclusively for the funding of Customs costs in processing all commercial imports.

Particular goods, including those imported under Schedule 8 of the tariff schedules (which includes products containing U.S. components--item 807.000 in the Schedules), are exempt from the fee.

Proposal

The Administration proposes to provide the Secretary of the Treasury the authority to prescribe and collect fees, on any basis that the Secretary deems appropriate, for the provision of any Customs service performed in connection with the processing of any merchandise that is entered into the United States or admitted to a foreign trade zone, or withdrawn from a warehouse, foreign trade zone, or other bonded status. These fees would apply indefinitely, instead of expiring at the end of fiscal year 1989. In addition, the Administration proposes that the revised user fee will apply to all imports as determined by the Secretary of the Treasury, after consultation with the heads of other departments.

Discussion

The application and extension of the user fee to all imports entering the country is consistent with the concept that those who benefit from specialized government services should pay for them directly. Last year, Congress took the first important step by imposing an ad valorem fee, and the Administration now proposes the enactment of authority to permit the full recovery of Customs costs incurred while processing cargo.

Revenue Impact

The elimination of the exception for the goods listed in Schedule 8, proposed to be effective on July 1, 1986 (the effective date of the legislation enacting the fee), is estimated to increase receipts by $0.1 billion in the 1988 fiscal year.

Extend the Airport and Airway Trust Fund Excise Taxes

Background

The Airport and Airway Trust Fund provides money for airport construction, facilities and equipment for the air traffic control system, research and development, and Federal Aviation Administration operating expenses. The trust fund is financed by a variety of user fees, including excise taxes on airline fares, aviation fuel, and air shipments. These user fees are scheduled to expire on December 31, 1987.

Proposal

The Administration proposes to extend existing airport and airway user fees for an additional two-year period.

Discussion

Consistent with its position that the users of Federal services should help pay for such services, the Administration believes that the Airport and Airway Trust Fund should continue to be funded by means of user fees such as the excise taxes described above.

Revenue Impact

The revenues from the extension of the user fees described above is not reflected in the $6.1 billion of new revenues shown in the Administration's budget proposal because it is an extension of an existing tax.

Increase Internal Revenue Service Funding

Background

As a result of the Tax Reform Act of 1986, it is easier for taxpayers to pay the correct amount of taxes and for the Internal Revenue Service ("IRS") to determine how much each taxpayer owes. Nevertheless, a large gap still exists between the amount of taxes owed and the amount paid.

Proposal

The Administration proposes to increase IRS funding for the 1988 fiscal year.

Discussion

Increased IRS funding for the 1988 fiscal year will ensure the smooth implementation of tax reform, will improve enforcement of the tax laws, and will help close the gap between taxes owed and taxes paid.

Revenue Impact

We estimate that the proposed increases in IRS funding will increase receipts in the 1988 fiscal year by $2.4 billion.

Authorize PBGC to Charge Variable-Rate Premium for Underfunded Defined Benefit Plans and Improve Minimum Funding Rules

Background

Under present law, if a single-employer defined benefit plan is terminated with assets insufficient to pay benefits guaranteed by the Pension Benefit Guaranty Corporation ("PBGC"), the PBGC pays the benefits provided by the particular plan, up to the guaranteed levels. Subject to certain limits, the PBGC generally guarantees nonforfeitable retirement benefits other than those that become nonforfeitable on account of the termination of the plan and those for which employees have not, at the time of termination, satisfied all of the applicable conditions for eligibility. Despite the 1986 increase in the premium rate to $8.50 per participant and recent restrictions on the circumstances under which employers may terminate underfunded defined benefit plans and shift pension liabilities to the PBGC, terminations of underfunded plans in failing companies are projected to increase the PBGC's single-employer deficit from $3.8 billion at the end of 1986 to $5.1 billion by the end of 1988. Benefit payments to retired workers are estimated to exceed PBGC premium receipts and income in 1987.

Pension plans can be underfunded on plan termination for many reasons. One of the most important and least justified reasons, however, is that the minimum funding rules applicable to pension plans are not adequate in many circumstances to assure that a pension plan's assets are sufficient to provide employees' accrued plan benefits. As a result, on the termination of an underfunded plan, not only is the PBGC forced to pay unfunded employer-promised benefits--including benefits that the employer has not yet been required to fund--but, because the PBGC does not guarantee all accrued benefits, employees also may lose important retirement benefits.

Proposals

To address the PBGC deficit, the Administration proposes to authorize the PBGC to charge higher premiums to those employers who do not adequately fund their pension promises. The annual premium payable by a single-employer defined benefit plan would consist of two elements. One element would consist of a flat per-participant charge applicable to all single-employer plans. The flat per-participant charge would be indexed annually to wage growth. The second element would be a variable-rate funding charge based on the difference between a funding target and the level of plan assets for plans with 100 or more participants. The total of these two premium charges would not exceed a maximum of $100 per participant for the 1988 plan year. The PBGC would be authorized to review the funding charge rate at 3-year intervals and could revise the rate by 50 percent either upward or downward without the need for Congressional action. A surcharge equal to a percentage of the funding charge otherwise due would be imposed for missed or waived contributions. The surcharge would not be taken into account in applying the annual limit on per-participant premiums ($100 for the 1988 plan year). The proposal would be effective January 1, 1988.

To address the long-term issue of defined benefit plan underfunding, the Administration also proposes to modify the termination liability and minimum funding rules for these plans to increase the accountability of employers for their pension benefit promises to employees. These proposals, which have been the subject of separate Administration testimony, would make an employer liable to employees and the PBGC for its unfunded pension promises on plan termination and would require that an employer more rapidly fund employees' benefits under an ongoing plan. The Administration considers these proposals to be essential not only to the long-term financial viability of the PBGC, but also to the security of employees' retirement benefits.

Revenue Impact

The PBGC estimates that the proposal to charge variable-rate premiums would result in PBGC outlay savings of $0.5 billion in fiscal year 1988.

Miscellaneous Provisions

Other revenue initiatives contained in the President's budget proposal, not discussed above, include user fees charged by the Internal Revenue Service including fees for the issuance of private letter rulings and determination letters ($60 million); increases in Nuclear Regulatory Commission fees ($73 million); initiation of Federal marine fishing license and other fees for commercial and recreational boating ($46 million); revenues from services provided by the Bureau of Alcohol, Tobacco and Firearms ($50 million); initiation of rail sector financing of a portion of windfall benefits ($92 million); increases in the contributions of the District of Columbia and its employees to civil service retirement ($10 million); and initiation of fees for the United States Travel and Tourism Administration ("USTTA") resulting in $10 million in receipts for the Treasury and $9 million of offsetting collections for USTTA.

Also, the President's budget proposal assumes a two-year extension of the pilot IRS tax refund offset program which is scheduled to expire on December 31, 1987. Under this program, the IRS is authorized to offset against a tax refund legally enforceable nontax debts owed other Federal agencies. Collections under this program in fiscal year 1988 are estimated to total $424 million.

* * *

This concludes my prepared remarks. I would be pleased to respond to questions.

Senator **Baucus**. Could you, please, list what you regard as taxes, which the Administration would not approve, on the one hand, and also list some revenue raisers, on the other hand, which the Administration would approve?

Could you supplement that by giving me some examples, too?

Mr. Ross. Sure.

Senator **Baucus**. You have already discussed this to some extent, but could you go down that list a little more exhaustively, please?

Mr. Ross. The list of revenue increases that we would approve is, in fact, the list presented in my written testimony and in the list in the President's budget.

The most obvious example, I suppose, of a tax increase that the President would not approve—illustrative, I think, of the distinction between a tax increase and the revenue initiatives in his budget—would be an increase in the rate of tax applicable to income of individuals or corporations.

That would be a general tax increase and would fall under the President's judgment against new taxes on the American people.

There are clearly other examples as well.

Senator **Baucus**. What about the other side? What about revenues that he would not disapprove?

Mr. Ross. Would not disapprove? That included a list——

Senator **Baucus** Would you again just outline the major items for me, please?

Mr. Ross. The major items in the President's budget—and they sum to $6.1 billion, as Chairman Bentsen suggested—would be—and I will simply go through the order that they are presented in my written statement.

That would be an extension of Medicare hospital insurance coverage to all State and local Government employees; as you know, under current law, employees hired before April 1, 1986 are to some extent grandfathered from application——

Senator **Baucus**. I know. That was the list that the Administration sent up earlier. Correct?

Mr. Ross. Yes, right.

Senator **Baucus**. That is $6 billion total?

Mr. Ross. $6.1, I think.

Senator **Baucus**. You know, we have a budget resolution here that requires us to raise more than $6 billion. What are some other revenues that the Administration would not disapprove?

Mr. Ross. I believe there is nothing on that list. I mean, there is nothing beyond the $6.1 billion.

Senator **Baucus**. Are excise taxes "taxes," or are those "revenues"?

Mr. Ross. Those are clearly taxes in the President's view, and he would not support an increase in excise taxes.

Senator **Baucus**. Would further loophole closing be taxes or be revenue?

Mr. Ross. The President would be opposed to further loophole closing as a revenue raising exercise.

Senator **Baucus**. Will the Treasury prepare a revenue estimate that it claims resulted in increased revenue as a consequence of the reduced capital gains tax? You said that happened in what year?

Mr. Ross. In 1978, as you know, there was a reduction in capital——

Senator BAUCUS. You said there was no revenue estimate.

Mr. Ross. I am confident we did not prepare an exact revenue estimate of the effect of that reduction. You would like to see an estimate of a reduction in that?

Senator BAUCUS. You said that the Treasury feels that there was a revenue increase as a consequence of that capital gains reduction, but you also said there was no precise revenue estimate.

And I am asking Treasury to provide this committee with a precise estimate.

Mr. Ross. We would certainly like to do what we can to accommodate you on that. The Treasury has issued a fairly lengthy report on this subject. I am not sure whether there is in this report—in fact, I believe there is not—a specific revenue estimate in the form you might see attached to legislative proposals.

I think it would be hard to reduce this report to simply a line of numbers; and the report, in fact, deals with a fairly complex analysis; but I will certainly take that request back with me, Mr. Chairman, and see what we can do.

[The information was not available at press time.]

Senator BAUCUS. What about a further reduction in the capital gains rate? You have said or implied that a further reduction would result in increased revenue.

Do you have, or does Treasury have, an estimate?

Mr. Ross. That is what I really meant when I said we had not prepared a revenue estimate. We do not have a revenue estimate of the current proposals to reduce the capital gain rate.

I did mention in my statement that there are some who believe, and there is a body of research to this effect, that a reduction in the capital gains rate would in fact result in an increase in revenue; but we have not prepared a revenue analysis of such proposals.

Senator BAUCUS. I would like Treasury to do so. If Treasury feels that is the case, it would be important for Treasury to indicate to the committee the amount of revenue.

Mr. Ross. I can understand. That is another request that I would be happy to take back. Again, I am somewhat fearful of the response to this very complicated issue; and I am not sure how quickly we can respond, but I will certainly take that request back with me and see what we can do.

[The information was not available at press time.]

Senator BAUCUS. You mentioned earlier that the Administration opposed loophole closing. Earlier this year, Chairman Rostenkowski and Chairman Bentsen and others introduced a bill to close a loophole in the estate tax for sales of securities to ESOPs. Will the Administration support that loophole closing?

Mr. Ross. I believe we would support that, and I can understand your asking why that is different than perhaps other loopholes.

Senator BAUCUS. That is right.

Mr. Ross. I think the distinction is that there was clearly an unintended effect of the legislation as enacted as opposed to what was understood at the time the 1986 Act was finalized.

I think we would support the legislation which, as I understand it, would simply conform the effect of the legislation to what was intended in 1986.

My earlier statements about loophole closing really addressed the general subject of should we go back through the Code and reexamine the tax base and perhaps identify other items that might well be adopted to expand the base.

Senator Sanford suggested one in his statement earlier today. I think that is an exercise the President would oppose as a revenue-raising initiative and really as an exercise that would reopen tax reform.

Senator BAUCUS. Senator Wallop, do you have any questions?

Senator WALLOP. Mr. Chairman, I do and I thank you.

Mr. Ross, I am somewhat cynical—if you will forgive me—about your statement to Senator Baucus that you didn't know how quickly you could respond with regard to revenue estimates on capital gains.

As I recall, during the tax markups, you were able to respond in less than eight hours. It would seem to me that there is something else at work here, and I cannot tell you how much I urge the Administration not to close its eyes to possible revenue-raising measures that provide tax relief.

I mean, it is an insanity to pretend that even if it exists, it wouldn't be of use. I would like to just explore a little of that with you.

Given that Treasury hasn't run numbers—which I am suspicious of but I will cede—does Treasury have a belief that a reduction in the maximum capital gains tax, either by rate reduction or some form of exclusion, would result in increased revenues in the short term for fiscal years 1988 through 1990?

Mr. Ross. Unfortunately, I am afraid I am going to trigger your cynicism again, but——

Senator WALLOP. It is not new on the part of estimators.

Mr. Ross. Senator Wallop, this is the report we did on the capital gains reduction in 1978; and simply by the volume of it, you can see that—in our view at least—it is a very complicated issue, and there is much academic literature on it, and there is some disagreement certainly in that literature.

It would be hard to reduce our current views to a "yes" or "no" response to your question. In part, I think it is important to recognize that the circumstances at the time directly affect the question.

For example, it is relevant to ask what stock of accrued but unrealized gains exist in the economy when you are contemplating a rate reduction. If there was a large stock of such gains, one could well conclude that the unlocking effect of a rate reduction would be substantial and would offset the effect of the reduction in rate on gains that would otherwise be realized.

That is simply an analysis that we haven't concluded in the present circumstances. I should note that this is an issue, we think, that is just as important as you and perhaps others on the committee and members of the public as well.

As you know, both the President and the Secretary were disappointed—to put it probably mildly—that the capital gains rate was increased as a consequence of tax reform.

Senator WALLOP. I would be hesitant if I were able to cite the 1978 study because it was uniformly incorrect in terms of experience. We now have some hands-on experience, and I will grant you that the circumstances are different; but it would seem that, inasmuch as the Administration was disappointed, it would at least still look at the opportunity to raise revenues by providing some measure of tax relief.

So, let me ask you this. Would Treasury oppose a deficit reduction plan which would include increased revenues from lower effective capital gains rates?

Mr. ROSS. Certainly not in concept. I mean, if the question were that everyone agrees that there is a positive revenue effect from a rate reduction in capital gains, then the Administration would quickly line up in support.

I don't think there is any doubt of that.

Senator WALLOP. Well, we can never get everyone to agree on anything around here, even were it to be engraved in some of the marble that is around and about.

But I think if there is a desire to see, there ought not to be a hesitancy to look.

Mr. ROSS. That is, of course, correct. And there is, in fact, I think no hesitancy on our part to look, and it is an issue we are looking at. Again, I don't mean to dodge the question, but it is a difficult one; and we are proceeding through it.

Some issues, as you know, we move through more quickly than others; but this is a terribly complicated one, and I suspect that really is the explanation for our perhaps more deliberate and less prompt response, but it is something we are looking at.

Since I am not myself directly involved in the estimating process, I am a little hesitant to provide you with an estimate of when we can provide you with a revenue estimate.

Senator WALLOP. I understand that, but let me join with the committee chairman in requesting that that figure be there and that you bring back advice to lock the closet of inhibitions and perhaps look at this from as realistic and as prompt circumstances as you can because, frankly, if it would work, it would seem to be so consistent with everything that the President—the Administration—has stood for that it is hard to determine whence the inhibition.

Mr. ROSS. I couldn't agree with you more. I mean, we certainly have no interest in a capital gains rate that is counterproductive of revenue. I think no one certainly at the Administration is interested in a rate that is above the revenue maximizing rate.

Senator WALLOP. Mr. Chairman, my time is up, but I really do urge that this be given serious attention. There is a lot of support for it, if it can be sustained.

If it can be sustained, we are sitting down there talking about increased competitiveness, increased flows of capital, increased job creation, and increased ability to attract capital, both at home and abroad.

All of those things would seem to make it a matter of some urgent concern, just in consistency with the regular conversation of today.

Mr. ROSS. I understand that, Mr. Wallop, and I will certainly report that back.

I would note—and this is to some extent, in fact, I think to a large extent—influencing our views on this issue. It is again our understanding that those who control the estimating process for budget reconciliation purposes would score this as a revenue loser.

Now, I am not certain of that, but that is our understanding.

Senator WALLOP. I am certain of it if they are the only players in the field.

Mr. ROSS. Yes.

Senator WALLOP. I mean, that is their nature. They are covetous folks, and they covet ideas as well as revenues.

But if there is another player in the field that can summon up a statistical argument in behalf of it, I think that that levels it considerably and quickly.

Mr. ROSS. Yes.

Senator WALLOP. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator. Mr. Ross, are there some proposals that the Administration regards as taxes and therefore would be opposed, but which are less objectionable than some others?

Or is the Administration opposed to all equally?

Mr. ROSS. Mr. Chairman, I think you have it right, in the latter characterization. I don't think there are degrees of opposition in the President's position against new taxes.

I think it is categorical, and it does not suggest that some are less offensive than others.

Certainly, that is his position as I understand it; and I see nothing to suggest otherwise.

Senator BAUCUS. Does this mean that the Administration sees no difference among that long list that the Joint Tax Committee has given the Ways and Means Committee and the Finance Committee? No difference?

Mr. ROSS. Well——

Senator BAUCUS. There is no difference. They are all exactly the same.

Mr. ROSS. Perhaps in his heart of hearts, there are differences; but it certainly is the Administration's articulated position that the opposition is in any event categorical. And I would not want to suggest that some are more attractive than others as perhaps an insinuation that that is the beginning of a bargaining process because I see no interest on the Administration's part in that.

Senator BAUCUS. Does the Administration agree that sales of assets are one-time revenue raisers?

Mr. ROSS. I think certainly specific sales are but the process of selling assets is not a one-time——

Senator BAUCUS. A specific sale?

Mr. ROSS. Certainly, a specific sale is a one-time revenue raiser.

Senator BAUCUS. Thank you very much, Mr. Ross. We appreciate your testimony.

The next witnesses are a panel consisting of Mr. Barry Bosworth, who is a Senior Fellow of Economics at The Brookings Institution; and Dr. Roger Brinner, Group Vice President and Director of the U.S. Economic Service, Data Resources, Inc. of Lexington, Massachusetts.

Gentlemen, welcome. Mr. Bosworth, why don't you proceed first?

STATEMENT OF BARRY P. BOSWORTH, SENIOR FELLOW OF ECONOMICS, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. Bosworth. Thank you. I was asked to appear before this committee on very short notice, and I don't have a lot of things——

Senator Baucus. I was asked to chair this hearing on probably even shorter notice. [Laughter.]

Mr. Bosworth. I don't have a lot of things that I would tell this committee; so I thought I would try to summarize my testimony, with a few opening remarks, and respond more to your questions.

First of all, in terms of the economic outlook, I think the major message that the Congress should keep in mind is, number one, that the economic outlook, while certainly not for robust growth over the next year or so, is pretty much a continuation of economic growth at the sort of modest 2.5 to 3 percent rates that we have had over the last couple of years.

There is not a near-term prospect of a recession. It is an economy that is strong enough to absorb a significant reduction in the budget deficit without running the risk of precipitating a recession.

I think the economy is shifting its structure a little bit in that, over the next year to two, economic growth is going to come primarily from the export sector.

After several years of disastrous performance on U.S. trade, the decline in the American dollar—I think—makes the prospects for economic improvement in the trade sector much better.

I might add that I think the current Congressional concern with the trade bill is typical of many of our public discussions. We spend a lot of time trying to address yesterday's problems.

I think that the trade problem is well on its way to resolution because the key to it is to try to find a way to increase the national savings rate so that the United States does not have to borrow so much overseas, as it presently is.

I think that the real problem that we face with the budget deficit is not that it is going to cause some near-term crisis. I think it is a mistake to keep focusing on threats that the economy will fall apart, that the dollar will plunge, etcetera, unless something is done about the budget deficit.

The real problem with the budget deficit is a long-term problem. It is the burden that we are placing on future generations because this country is simply abandoning any notion of additional capital formation in future years.

After starting out with an economic program in 1981 that said the primary national problem was slow economic growth and we had to find a way to increase capital formation, the results of that economic program are that we now have the lowest rate of national capital formation that we have had in our history.

We are in a situation in which a very low private savings rate—that has always been low by international standards—we now require that two-thirds of that private savings be devoted simply to balancing the budget deficit, leaving us with less than three percent of our national income available for capital formation.

And the basic reason that we have a trade deficit today is that, given that we can only finance three percent of our national income in the form of capital formation and we have a rate of net investment at present of about six percent, we have to borrow half of all the funds to finance capital formation in this country overseas.

And the mechanism in the first half of the decade by which we have done that is the Government's competition for funds and capital markets drove U.S. interest rates way above levels in the rest of the world.

The fact that foreigners could earn a higher rate of interest here in the United States led to a tremendous increase in the demand for dollars and drove up the exchange rates.

The results of that are simply that we have priced American goods out of world markets.

In the last year, I think the Congress—the Government as a whole—has made considerable progress in reducing the magnitude of the budget deficit. I know that they did not meet the Gramm-Rudman targets, but the major reason for that was that the budget deficit in 1986 was far larger than was anticipated—coming in at about $220 billion.

The current estimate for the 1987 fiscal year is that the budget deficit will decline to about $170 billion. That is substantial progress.

The real threat we face now, however, is that for fiscal year 1988, the budget deficit may begin again to increase.

I think the basic goal of the Congress should be to continue to make progress in reducing the budget deficit in 1988 in an order of magnitude of something around $30 to $40 billion a year.

In other words, try to bring the budget deficit down well below $150 billion, perhaps $140 billion.

I am also convinced, after six years of endless rankling between the Administration and the Congress, that we are never going to reach agreement to do this exclusively on the expenditure side.

The President wants to protect defense programs; the Congress wants to protect nondefense programs. I think the reality of the situation is that any significant effort to reduce the budget deficit is going to have to involve tax increases and that now is the time to begin to seriously consider the form that those tax increases should take.

So, my basic message I think would be that it is important to continue to try to reduce the budget deficit. It is the primary economic issue that the country now faces.

And we should not depart from that by fears that have been raised in some current forecasts that such actions would precipitate a recession here in the United States.

I think we are still faced basically with a very strong domestic economy in the short run that badly needs action to address the longer term problems of a lack of national savings.

Senator BAUCUS. Thank you very much, Dr. Bosworth. Dr. Brinner, why don't you proceed?

[The prepared written statement of Mr. Bosworth follows:]

Testimony

of

Barry P. Bosworth

before

The Senate Finance Committee

July 15, 1987

I must confess to some reservations about appearing before this committee. Economists are often accused of being boring and certainly this is not an exciting period for the U.S. economy. It is often difficult to sustain the interest of the public and the Congress in economic policy issues, except in an atmosphere of crisis and today we are not faced with a crisis. There is, instead, the slight stench of decay.

On the surface the U.S. economy should continue in 1987-88 to perform as well as it has over the last two years. Overall, growth is expected to average 3 percent annually into the middle of 1988. While that growth rate may seem low, given the slower growth of the labor force and the essential absence of any improvement in productivity, it should be enough to maintain unemployment at about 6 percent of the workforce. Domestic inflation shows no signs of acceleration, and even with higher import prices, the increase in consumer prices should average less than 5 percent in 1987 and 1988.

A sharp reduction in the budget deficit has held down growth in the first half of 1987, but a strong recovery in the trade balance should provide significant stimulus for the remainder of 1987 and 1988. In addition, the 1986 increase in business taxes had less of a depressive effect on investment than was claimed at the time that the bill was passed eliminating one area of potential weakness. Finally, the threat of sharply higher interest rates, which would have depressed housing demand, has receded.

In light of this outlook, one might ask "What's the problem?" There are, I believe, two fundamental problems that are reflective of the underlying decline of the American economy. First, productivity growth, which propelled the expansion of the U. S. economy in the postwar period, has come to an end. It averaged 3 percent per year between 1947 and 1973, but it fell to less than 1 percent annually over the last 13 years. It is also clear that the much-advertized supply-side economic recovery program of 1981 has been a colossal failure--the growth of productivity has continued at a 1 percent annual rate in the 1980s.

Productivity may appear to be an abstract concept of economists, but the consequences of slow productivity growth are evident in a drastic reduction of gains in the living standards of American workers. The real income of the median American family is today no higher than that of 1969. While demographic factors have played a role in these developments, the average real wage rate (adjusted for inflation) of American workers has fallen 6 percent in the last 10 years and is now the same as that of 1969.

While we read reports of sharply higher incomes in some occupations, it is clear that those gains are occurring only at the expense of lower real wages for others--an increasingly unequal distribution of income.

While the cumulative effects of slower economic growth now amounts to an average income loss of 30 percent--if the productivity slowdown had never occurred average real incomes would be 30 percent higher today--the average American voter remains unconcerned.

The second major problem has been of more recent origin. In the 1980s, despite the lack of any prospects for higher real incomes, Americans decided to go on a consumption binge, reducing the national saving rate and borrowing heavily overseas. Despite the assurances of supply-side economists, taxpayers treated the 1981 tax reduction just like any other income gain--they spent it. In addition, public expenditures, principally for defense and interest payments, have continued to expand as a share of national income. The result has been a sharp plunge in the net national saving rate--which was already low by international standards--to less than 3 percent in 1986. Last year, the nation used two-thirds of all private saving simply to cover the budget deficit, and we financed half of domestic investment by borrowing overseas (see table 1). As a nation we are living far beyond our means, enjoying today's consumption; but future generations will have to pay as they struggle to manage the public and foreign debts run up during the 1980s.

One current cost of our economic policies has attracted public attention--the trade deficit. But again it has proved more popular to blame foreigners for our problems rather than seeing the poor trade performance as being a consequence of our own policies.

I will not argue that other countries do not discriminate against American trade. While I believe that such discrimination does exist--just as the U. S. discriminates against their goods--I do not see how the situation could have suddenly changed in the 1980s so as to shift the United States from a surplus prior to 1981, to the huge deficit will which we are now faced. Nor has the U.S. trade deficit increased disproportionately with individual countries, such as Japan, whom we would like to blame for our problems. The truth is that the United States now has a trade deficit with every region of the world.

Instead, the trade deficit is closely connected to the collapse of productivity growth and saving here in the United States. This linkage is best understood by focusing on the fundamental accounting identity outlined in table 1. This identity is that a nation's current account deficit with the rest of the world (net foreign borrowing) must equal the difference between its national saving and investment. When, as has been the case in the United States in the 1980s, investment exceeds saving, we must borrow abroad--importing more than we export.

The economic mechanism is quite simple. Interest rates in the United States that are higher than those abroad attract foreign capital, increasing the demand for dollars, and thus the U. S. exchange rate. That higher exchange rates in turn raise the price of American exports and lowers the price of imports. Over the first half of this decade, through a

60 percent appreciation of the dollar, we priced ourselves out of foreign markets. It is also clear from the table that it has been a drop in national saving, not a rise in investment, which fueled the growth of the trade deficit.

It is possible, of course, to argue that the causation between the trade deficit and national saving is the opposite of that which I have suggested--foreign discrimination against American goods led to a trade deficit, which, in turn, by depressing domestic growth led to a budget deficit. Such an argument ignores, however, the fact that the budget deficit preceeded the trade deficit; and an economy with a steadily falling unemployment rate is not consistent with the view that the trade deficit held down employment in the United States.

Within the last year, the whole process has begun to operate in reverse. The budget deficit will decline substantially in 1987 from $220 billion in FY 1986 to about $170B in 1987. Somewhat less favorably, a sharp fall in domestic investment in 1986 has further relieved the pressures on domestic capital markets. The result has been a sharp fall in interest rates and a reversal of the previous run-up of the dollar.

At present exchange rates the trade balance should improve throughout 1987 and 1988; but the relative cost of American goods is still above the levels of 1980, and current projections imply that the current account deficit will remain above $100 billion in future years.

If the current progress in reducing the trade balance is to be sustained, it is crucial that it be matched by equal improvement on restoring domestic saving. In a practical sense I believe that efforts to raise the private saving rate have proved to be futile, and that significant gains in national saving can only be achieved by reducing government dissaving--the budget deficit.

Congress has made considerable gains in this regard since 1986, but there is a very real danger that the FY 1988 budget deficit could again begin to rise unless strong actions are taken this year. After 6 years of haggling with the President over the expenditure programs, it also is clear that any real progress on reducing the budget deficit must involve a substantial tax increase--largely eliminating the reductions of 1981. I also believe that the economy is well suited to absorb such a tax increase over the next several years because of the strength of the export sector.

Finally, the key element of any government program to expand productivity growth must involve an increase in domestic capital formation. Yet, it would be pointless to seek to encourage higher rates of domestic investment at a time when we cannot finance current levels without heavy reliance on foreign borrowing. Thus, the major priority of the Congress should be to cut the budget deficit thereby restoring the national saving rate to pre-1980 levels. The short-term benefits will be evident in an improved international competitive position and the longer-term benefits will take the form of higher rates of capital formation and economic growth.

Table 1. Net Saving and Investment as a Share of Net National Product, United States, 1951-86

Percent

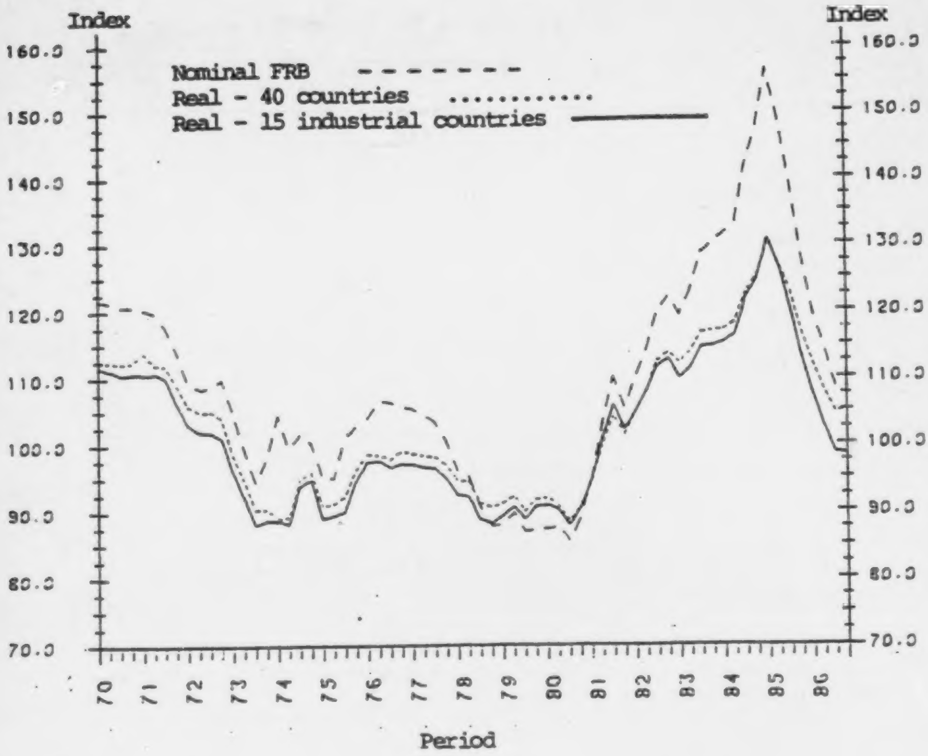
Item	Percent of Net National Product				
	1951-60	1961-70	1971-80	1981-85	1986
Net Saving[a]					
Private Saving[b]	8.7	9.4	9.7	8.4	8.1
Government Saving	-0.7	-1.0	-2.0	-4.6	-5.4
National Saving-Investment	8.0	8.4	7.7	3.8	2.6
Net Foreign Investment	0.3	0.7	0.3	-1.3	-3.7
Net Domestic Investment	7.7	7.7	7.5	5.1	6.4

Source: United States Department of Commerce.

a. Net saving and investment equal the gross flow minus capital consumption allowances (the depreciation of existing capital). Net National Product equals Gross National Product minus capital consumption allowances

b. Business and Household Saving. Employee pension funds of State and Local governments are allocated to household saving to match the treatment of private pension funds.

Figure 1 . Alternative Exchange Rate Indexes, 1980-82 = 100



Source: Board of Governors of Federal Reserve and Morgan-Guaranty.

STATEMENT OF DR. ROGER E. BRINNER, GROUP VICE PRESIDENT AND DIRECTOR, U.S. ECONOMIC SERVICE, DATA RESOURCES, INC., LEXINGTON, MA

Dr. **Brinner**. Thank you very much, Mr. Chairman and committee members. I was asked to answer several questions during my testimony.

First: Will renewed efforts to cut the deficit push the U.S. into a recession in the short run? Second: Is deficit reduction still a high priority action to improve medium and long-term growth and living standards? And third: What types of tax increases would I recommend for a macroeconomic perspective?

Let me summarize my conclusions as follows. First, I very much agree with Mr. Bosworth that the economy will definitely be strong enough to accommodate significant Federal deficit reduction. We are in a transition from domestic demand leading the economy to exports, but that transition appears to be going sufficiently smoothly that I am not worried about a recession in 1987 or really 1988.

Second, deficit reduction is clearly highly desirable from a medium-term and long-term point of view. It is necessary in fact to make room for more private investment, to avoid greater foreign indebtedness, and to enhance the U.S. living standard.

I again endorse Mr. Bosworth's comments. The extent to which we have been able to increase our capital stock has been through borrowing abroad.

Therefore, we don't own that increase in the capital stock; someone else does.

Third, assuming that your colleagues have done their best in compromises with the Administration and among one another in cutting Federal expenditures, the best option is by far a personal income tax surcharge.

Let me augment that with my fourth conclusion, and that is that excise tax increases can utterly fail to reduce the Federal deficit because of the inflation shocks they will generate.

I support the testimony of the Senators who preceded me regarding the impacts from an income distributional point of view of any one of these taxes—the excise tax increase taken alone, that would be a problem; but beyond that, the inflation that is created in addition to just the general economic slowing effects of a tax increase would cause revenue losses elsewhere in the system, expenditure increases elsewhere, and I will show you later some details, for example, of a 10 cent gasoline tax or a $5.00 per barrel oil import fee.

If the reason you are considering these taxes is to close the deficit, then you ought to conclude that it is not worth pursuing those taxes.

I will skip over the detail in my testimony about the strength of the economy and concentrate on the analysis of good and bad ways to cure the deficit.

Any deficit cure should be judged by its impact on domestic business or human capital investment, not just how rapidly it will contribute to restoring budget balance.

Therefore, expenditure restraint must be carefully targetted, protecting spending on research, education and infrastructure improvement, while cutting deep into services and Government operations that are not cost effective, but are luxuries in today's environment.

Examples of categories deserving hard pruning include Government pension and farm subsidy programs.

Tax increases should be primarily directed at households, and they should be broad-based unless a genuine case can be made for a "user fee." Tax reform has already done more than enough damage to corporate profitability, fixed investment, and international competitiveness.

Therefore, I do recommend the personal income route as the alternative. Good taxes would include a national consumer sales tax or a personal income tax surcharge.

Because of my reluctance to begin a whole new tax structure, such as a national sales tax, therefore I feel the personal tax is the preferred alternative.

Bad taxes, again, let me emphasize, would include oil import fees and tariffs that are not strategically tied to closed overseas markets.

On page 9 of my testimony, I show you an exhibit of the impacts of an income tax surcharge combined with some additional spending restraint. What I have done is put through an economic model simulation of five percent personal tax surcharge effective January 1, 1989, along with an additional $30 billion of expenditure cuts.

This is a five percentage point surcharge, not an increase in marginal rates by five points. Everyone would pay an exactly proportional increase in their taxes.

Therefore, I think this is both the most fair way to increase revenues and also a way to avoid fighting all of the battles that were fought during tax reform.

Don't change any of the definitions, any of the base issues. Don't try and fiddle with income distribution issues. Simply put on a surcharge.

Because the package cumulates substantial reductions in the total debt, and because lower Federal borrowing reduces interest rates, interest expenditures would fall on their own by as much as $20 billion and the Federal deficit by as much as $71 billion by 1992.

So, I recommend this package very much.

Let me just go over something for a minute.

Senator Baucus. Briefly.

Dr. Brinner. Yes. Let me call your attention to the table on page 15 that illustrates the impacts of one particular excise tax, a 10 per gallon gasoline tax.

There I note, for example, that although it would directly raise some $11 billion in a typical year—let's say 1988—that the weakness it would induce elsewhere in the economy would cause other revenues to fall by $7 billion.

Therefore, total Federal revenues would be up by only $4 billion.

In addition, because the Federal Government has to purchase gasoline because the Federal Government has to pay individuals whose pay moves up with general inflation, the Federal Government would end up spending an extra $4 billion in that same year.

Revenues up by $4 billion; expenditures up by $4 billion; the deficit not affected at all. So, therefore, an excise tax increase from a macroeconomic point of view as well as the micro prospective presented earlier is a bad idea in my view.

Thank you very much.

Senator BAUCUS. Thank you, gentlemen.

[The prepared written statement of Dr. Brinner follows:]

DRI Data Resources

DEFICIT REDUCTION AND TAX POLICY OPTIONS

* * * * * * * * *

Presented by
Dr. Roger E. Brinner
Chief Economist and Group Vice President
Data Resources

* * * * * * * * *

Testimony Before
The Senate Committee on Finance
July 15, 1987

Data Resources, 24 Hartwell Avenue, Lexington, Massachusetts

DEFICIT REDUCTION AND TAX POLICY OPTIONS

- The Economy Will Be Strong Enough in 1987 and 1988 to Accommodate Federal Deficit Reduction

- Deficit Reduction is Still Highly Desirable--It Would Make Room For More Private Investment, Avoid Greater Foreign Indebtedness, and Enhance the U.S. Living Standard

- Assuming Your Colleagues Have Done Their Best in Cutting Federal Expenditures, the Best Option is a Personal Income Tax Surcharge

- Excise Tax Increases Can Utterly Fail to Reduce the Federal Deficit Because of the Inflation Shocks They Generate

THE NEAR-TERM OUTLOOK FOR THE UNITED STATES

1. Domestic Demand Is Slowing, But Output Growth Will Be Relatively Strong in 1987 Due to Exports and Inventories

- Consumers remain willing to spend, but their income growth is moderate.
- Their indebtedness is very high, but the stock market surge has increased their wealth.
- Investment is being slowed by tax reform and weak oil prices.
- Rental housing is being hurt by tax reform, and rising mortgage rates will cause single-family housing to decline.
- The budget deficit will be cut, although by much less than the Gramm-Rudman amendment mandates.
- The lower dollar is significantly improving the real trade balance, but the rising import prices are almost balancing the higher export volumes to minimize improvement in the current dollar deficit.
- Nonetheless, improvements in foreign trade will account for over one-third of U.S. real economic growth in 1987.

2. Inflation Is Returning, But Restrained Labor Costs Call for Optimism

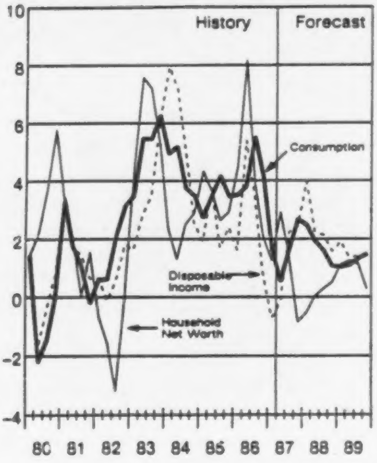
- Wage increases have been very restrained and offer the best hope for moderate future inflation if employers and employees continue to respond intelligently to the hard facts of international competition.
- The prices of goods consumed in the United States will rise a full 1% per year more rapidly than the prices of goods produced by U.S. firms. Wages must not be allowed to rise more rapidly than the latter plus any genuine productivity gains.
- Consumers will experience the greatest price pressures, with imported goods prices rising sharply.
- Capital goods prices, adjusted for quality improvements, will rise only modestly due to extensive global competition and technological breakthroughs.

3. The Federal Reserve Will Let Interest Rates Drift Upward in Response to Higher Inflation, the Weaker Dollar, and Poor Progress in Federal Deficit Reduction.

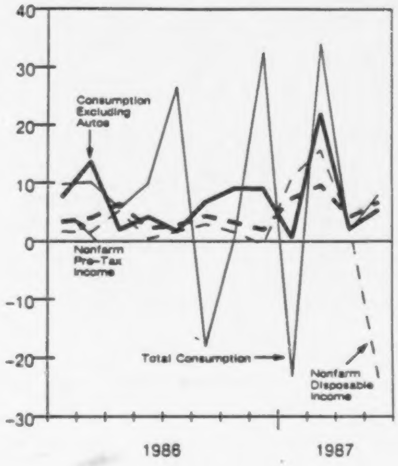
- Bond rates are certainly past their early 1987 trough and are unlikely to decline until mid-1988.
- Although the basic pattern of erratically rising rates is easily defended, the exact timing of bond rate movements will be dominated by unpredictable expectation shifts.
- But the problems of LDC debt and the sluggish world economy should limit the rise in U.S. short-term rates; other nations will be pressured to cut their rates to stimulate growth and support the dollar.

The Consumer Continues To Spend but Will Follow, Not Lead, the Economy

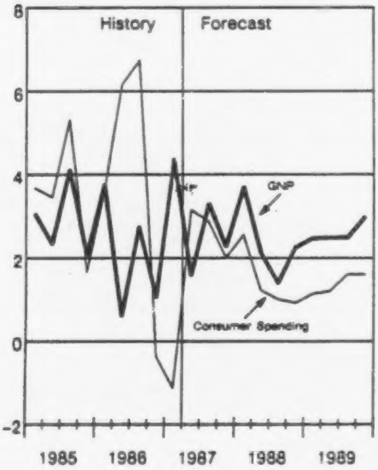
Growth in Real Consumption, Disposable Income, and Household Net Worth
(Three-quarter moving average, percent change)



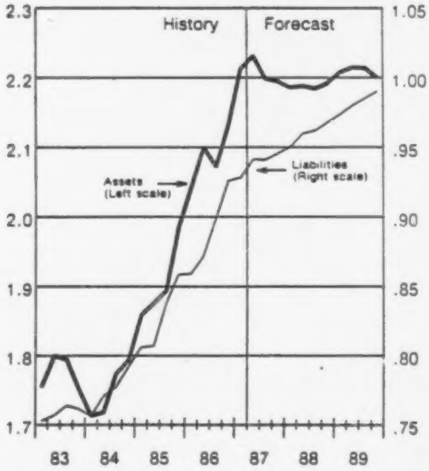
Growth in Income and Purchases
(Percent change, annual rate)



Growth in Real GNP and Consumer Spending
(Percent change, annual rate)

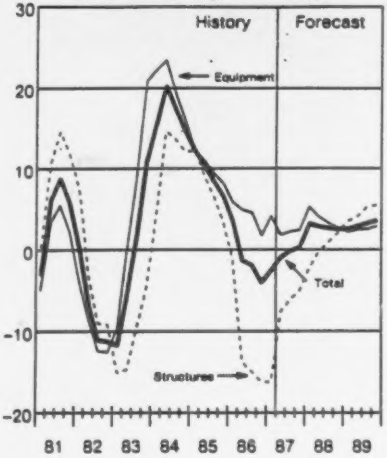


Personal Assets Support Saving
Household Financial Assets and Liabilities as a Share of Disposable Income

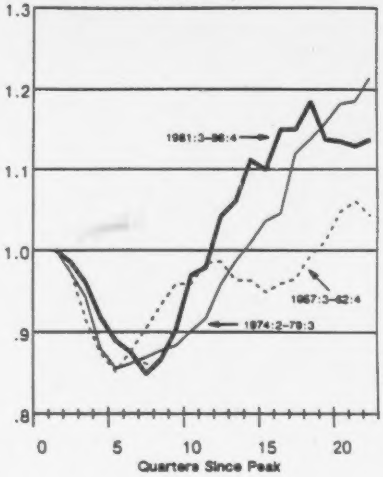


But Tax Reform and Weak Oil Prices Have Cut Investment and Will Keep it Subdued Through the End of the Decade

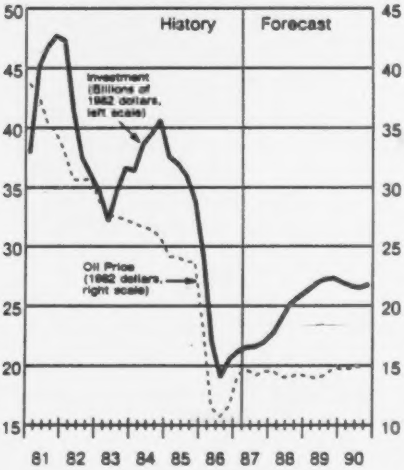
Tax Reform Will Damage Business Fixed Investment
(Year-over-year percent change)



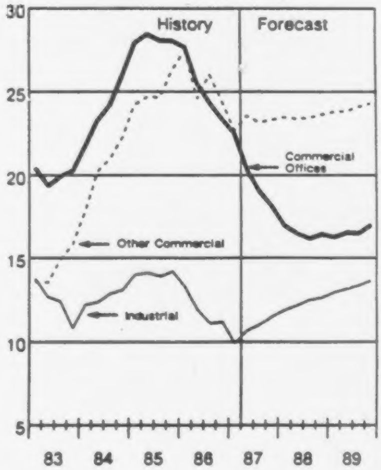
The Cycle in Business Fixed Investment
(Peak=1.0)



Investment in Mining and Petroleum Structures and the Real Per-Barrel Price of Domestically Produced Oil

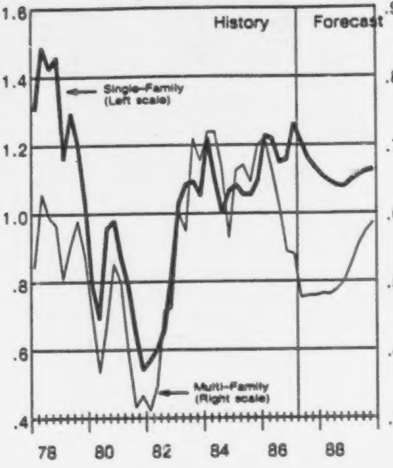


Investment in Nonresidential Buildings
(Billions of 1982 dollars)

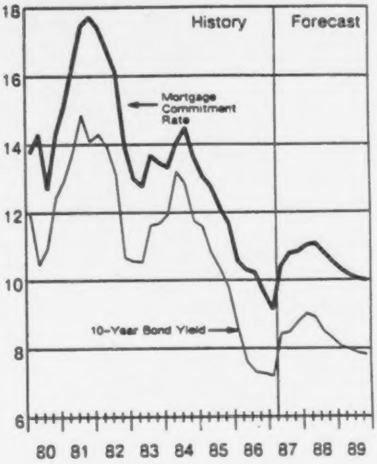


Single-Family Housing Will Be Trimmed by Higher Mortgage Rates, But Multi-Family Construction Has Been Badly Hurt By Tax Reform

Single- and Multi-Family Housing Starts
(Millions of units)

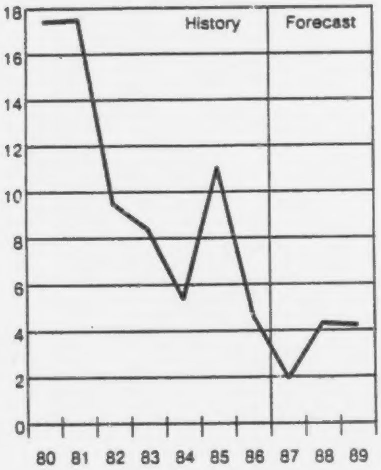


Mortgage Rate Past Its Trough: Commitment Rate and 10-Year Bond Yield

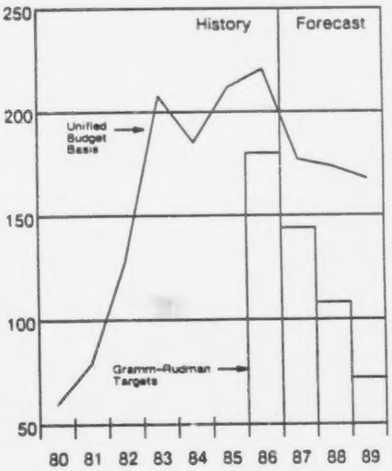


Federal Spending Slows But Not Enough to Meet Targets

Federal Spending Growth
(Percent change, unified budget basis, fiscal years)



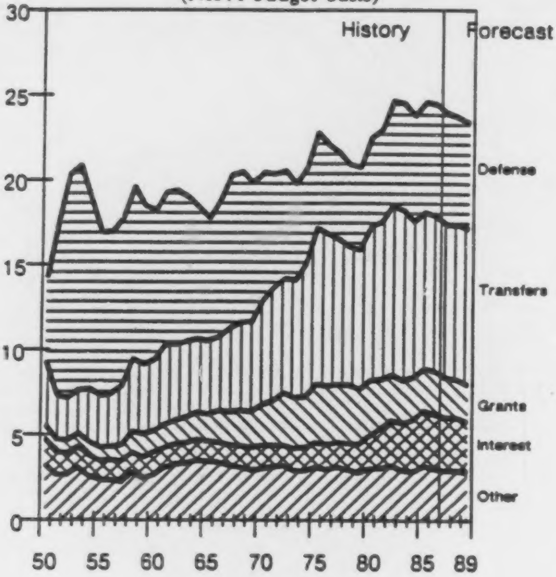
Unified Budget Deficits and Targets
(Billions of dollars, fiscal years)



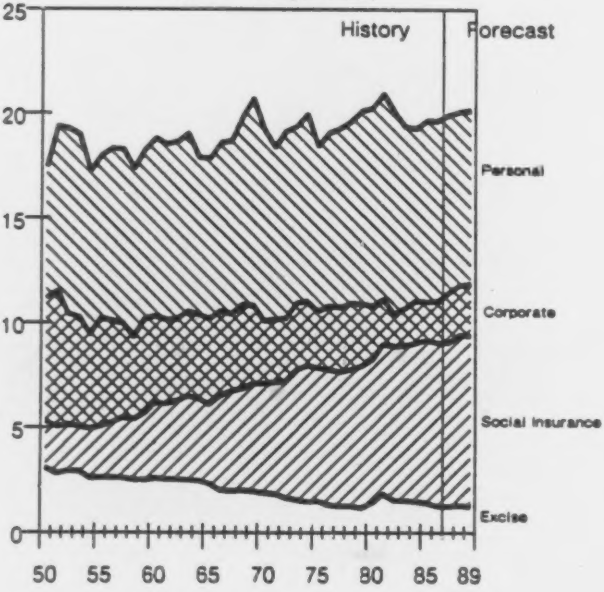
Federal Receipts and Expenditures

	Fiscal Years						
	1983	1984	1985	1986	1987	1988	1989
Billions of Dollars (Annual rate, SA)							
Federal Government Receipts	649.3	709.4	771.4	814.8	875.7	930.2	990.5
Annual Rate of Change	1.9	9.3	8.7	5.6	7.5	6.2	6.5
Personal Tax and Nontax Receipts	297.2	300.9	338.1	356.8	376.9	385.9	405.4
Corporate Profits Tax Accruals	55.4	76.0	71.8	79.8	103.2	109.3	120.6
Indirect Bus Tax and Nontax Accruals	50.1	55.1	56.1	53.2	53.6	59.5	62.9
Windfall Profits Tax Revenues	11.5	8.3	6.1	2.1	0.0	0.0	0.0
Contributions for Social Insurance	246.6	277.4	305.4	324.9	342.0	375.6	401.6
Receipts as Percent of GNP	19.5	19.2	19.6	19.6	20.0	20.0	20.1
Effective Tax Rates (Percent)							
Corporate Income	28.9	31.9	32.7	34.5	39.2	41.1	39.8
Investment Credit							
Equipment	9.71	9.66	9.68	2.43	0.00	0.00	0.00
Public Utility Structures	10.00	10.00	10.00	2.50	0.00	0.00	0.00
Personal Income	12.9	11.7	12.3	12.2	12.4	11.9	11.8
Social Insurance	15.0	15.4	15.8	15.9	15.9	16.4	16.6
Federal Government Expenditures	833.7	874.1	962.5	1025.3	1051.5	1106.2	1159.6
Annual Rate of Change	10.2	4.9	10.1	6.5	2.6	5.2	4.8
Purchases of Goods and Services	287.8	298.0	341.2	368.4	377.7	392.7	407.9
National Defense	210.4	229.2	253.6	274.9	288.3	296.6	308.7
Other	77.4	68.8	87.6	93.5	89.5	96.0	99.1
Transfer Payments	347.3	352.6	374.4	393.7	408.5	436.5	467.4
To Persons	339.5	342.7	361.0	379.6	394.7	421.8	451.8
To Foreigners (Net)	7.8	9.9	13.4	14.1	13.8	14.8	15.6
Grants-in-Aid to State and Local Governments	85.8	90.9	97.8	105.0	103.5	105.6	108.4
Net Interest Paid	90.8	109.6	128.3	135.4	137.6	144.3	148.2
Subsidies Less Current Surplus of Government Enterprises	21.5	23.1	20.8	22.8	26.2	27.2	27.7
Wage Accruals Less Disbursements	-0.4	0.1	-0.1	0.0	2.0	0.0	0.0
Expenditures as Percent of GNP	25.1	23.7	24.4	24.6	24.1	23.8	23.5
National Income and Product Accounts Surplus or Deficit (-)	-184.4	-164.8	-191.2	-210.6	-175.8	-176.0	-169.1
Unified Budget (Fiscal Years, AR) Fiscal Years, AR)							
Receipts	600.6	666.5	734.1	769.1	831.9	878.7	928.9
Outlays	808.3	851.8	946.0	989.8	1008.8	1052.2	1096.5
Surplus or Deficit (-)	-207.7	-185.3	-211.9	-220.7	-176.9	-173.5	-167.6
Gross Public Debt Securities	1575.6	1821.9	2109.3	2491.5	2806.3	3056.1	3303.4
Billions of 1982 Dollars (Annual rate, SA)							
Federal Government Expenditures	809.5	819.3	870.6	905.0	911.1	915.4	920.1
Annual Rate of Change	5.7	1.2	6.3	4.0	0.7	0.5	0.5
Defense Purchases	204.3	215.8	232.4	246.7	256.5	253.0	252.2
Annual Rate of Change	7.7	5.6	7.7	6.1	4.0	-1.4	-0.3
Nondefense Expenditures	605.2	603.4	638.2	658.3	654.6	662.4	667.9
Annual Rate of Change	5.1	-0.3	5.8	3.2	-0.6	1.2	0.8
Nondefense Purchases	76.7	66.4	80.3	85.2	83.2	82.8	81.9
Annual Rate of Change	-1.1	-13.4	20.9	6.0	-2.3	-0.5	-1.1
Transfer Payments	336.7	329.2	337.7	346.1	347.7	356.4	366.0
Annual Rate of Change	6.4	-2.2	2.6	2.5	0.5	2.5	2.7
Grants-in-Aid	82.8	83.6	85.4	88.1	83.5	81.3	79.7
Annual Rate of Change	-2.9	1.0	2.1	3.2	-5.2	-2.6	-1.9
Net Interest Paid	88.2	102.5	116.0	118.9	117.8	119.4	118.2
Annual Rate of Change	5.8	16.2	13.2	2.6	-1.0	1.4	-1.0
Subsidies Less Current Surplus of Government Enterprises	20.9	21.7	18.8	20.0	22.5	22.5	22.1
Annual Rate of Change	53.8	4.1	-13.2	6.1	12.4	0.1	-1.6

Federal Expenditures by Function
as a Percent of GNP
(NIPA budget basis)



Federal Receipts by Source
as a Percent of GNP
(NIPA budget basis)

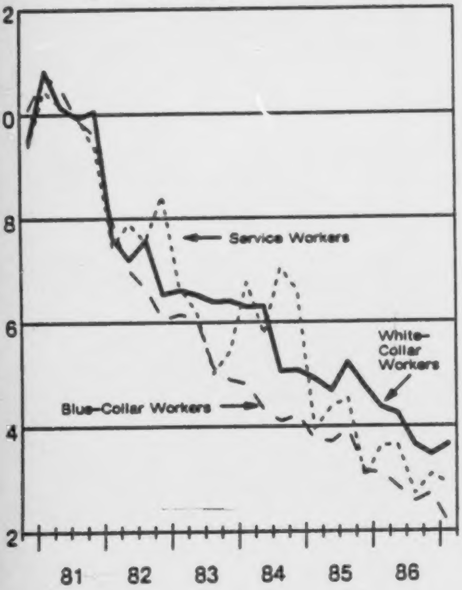


Inflation Fundamentals

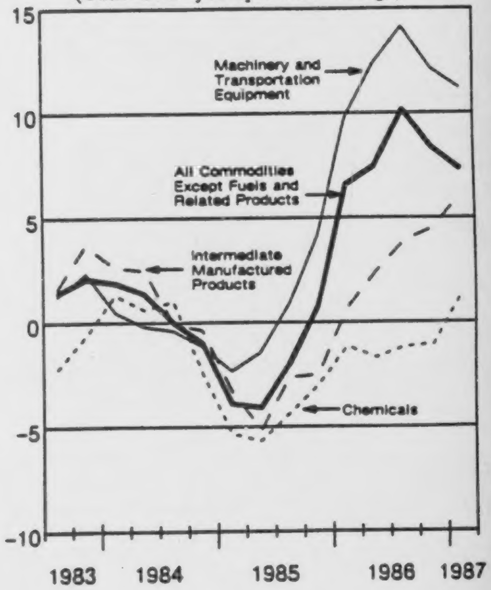
	History				Forecast		
	1983	1984	1985	1986	1987	1988	1989
Core Ingredients							
Annual Rates of Change							
Hourly Compensation	4.3	4.0	4.0	3.0	2.5	4.6	4.6
Output per Hour	3.3	1.8	0.5	0.7	0.4	1.3	1.0
Unit Labor Cost (smoothed)	3.6	1.6	2.2	2.3	1.9	3.8	3.4
CPI	3.2	4.3	3.6	1.9	3.9	4.6	4.7
GNP Deflator (fixed weight)	3.8	3.8	3.3	2.3	3.1	3.7	4.0
GNP Deflator - Unit Labor Costs	0.3	2.1	1.1	0.0	1.2	-0.1	0.6
Factors Affecting Core Ingredients							
Unemployment Rate (%)	9.6	7.5	7.2	7.0	6.5	6.4	6.4
Mfgr. Cap. Util. Rate	0.740	0.805	0.801	0.798	0.798	0.799	0.802
Crude Oil - ($/bbl)	29.35	28.87	27.00	14.31	17.17	17.63	18.50
- Change ($/bbl)	-4.25	-0.48	-1.87	-12.69	2.86	0.46	0.87
Nonoil Import Prices	-2.4	-0.9	-2.6	3.2	NA	NA	NA

Recent Inflation Evidence

The Employment Cost Index for Compensation
(Year-over-year percent change)



U.S. Import Price Indices
(Year-over-year percent change)



GOOD AND BAD WAYS TO CURE THE FEDERAL DEFICIT

- The deficit is a problem because the federal government is forced to compete aggressively for global savings, resulting in high U.S. interest rates relative to the rest of the world. This curbs productivity-enhancing U.S. investment and yields ownership to foreign savers.

- Any deficit cure must be judged by its impact on domestic business or human capital investment--not just how rapidly it will contribute to restoring budget balance.

  - Expenditure restraint must be carefully targeted, protecting spending on research, education, and infrastructure improvement while cutting deep into services or government operations that are not cost-effective or that are luxuries in today's environment. Examples of categories deserving hard pruning include government pension and farm subsidy programs.

  - Tax increases should be primarily directed at households and be broad-based unless a genuine case can be made for a "user fee." Tax reform has already done more than enough damage to corporate profitability, fixed investment, and international competitiveness. Foreign producers can also be made to pay taxes for participating in the U.S. market. Good taxes would include a national consumer sales tax (better than a broad business transaction tax because capital expenditures would not be taxed) or a personal income tax surcharge. Bad taxes would include oil import fees and tariffs that are not strategically tied to closed overseas markets.

Impacts of an Income Tax Surcharge Plus Additional Spending Restraint

	Baseline DRI Forecast	Additional Fiscal Restraint
Inflation, Growth, and Employment		
Consumer Price Inflation		
Average 1988-92	4.7	4.3
1992	4.3	4.2
Real GNP Growth		
Average 1988-92	2.7	2.7
1992	2.4	2.9
Unemployment Rate		
Average 1988-92	6.1	6.3
1992	5.8	5.9
1992 Federal Budget (Billions of dollars)		
Receipts	1,225.4	1,223.2
Outlays	1,359.6	1,286.3
Interest	178.7	156.5
Deficit	134.2	63.1
Other Key Indicators (Average 1988-92)		
10-year Govt. Bond Rate (%)	8.21	7.13
Fixed Investment as % of GNP	15.3	15.7
Current Account Deficit (Bil of $)	109.1	107.2

A solid deficit reduction package would include stricter spending restraint coupled with a personal income tax surcharge. The table above summarizes the macroeconomic impacts of instituting a 5% personal tax surcharge (effective January 1, 1989), along with spending cuts of $30 billion (phased in over fiscal 1988-90, with $15 billion in defense, $5 billion in nondefense purchases and state aid, and $5 billion in federal subsidy programs).

The proposed tax surcharge is not a 5 percentage-point increase in marginal rates but rather a charge of 5% added to the final tax calculation; the 15% and 28% marginal tax rates under tax reform would thus be effectively increased to 15.75% and 29.4%. If necessary to attract sufficient votes and overcome presidential opposition, the legislation could contain an explicit "sunset" provision for automatically eliminating the surtax whenever the budget deficit in the prior fiscal year fell below a specified level.

Because the spending cuts cumulate to substantial reductions in the total debt and because lower federal borrowing reduces interest rates, interest expenditures could fall as much as $20 billion and the federal deficit as much as $71 billion by 1992. The extent of these savings clearly depends on the Federal Reserve's inflation-control efforts. If credit were not eased in response to the fiscal restraint, the inflation reduction could be as great as 0.9% by 1992.

To evaluate budgetary and macroeconomic impacts of alternative taxes, perhaps the most important factor to take into account early in the analysis is the inflation impact of any proposed levy.

- All taxes designed to raise the same revenues (before considering economic feedbacks) will tend to slow down the economy as consumer purchasing power is reduced.
- This weakness can be offset to the extent that the Federal Reserve is prepared to inject offsetting monetary stimulus.
- The Federal Reserve's primary responsibility in macroeconomic management is control of the price level. Therefore, the Federal Reserve can be expected to provide more stimulus to offset tax cuts which are not inflationary and less stimulus or none at all to offset those that are inflationary.

The direct inflation impact of a tax depends on:

1. Whether the producer or the factor of production taxed will respond by absorbing the tax or by passing the tax on to the consumer through higher prices. Most economists would agree that an *income tax* change will only result in very small reductions in labor and saving supplies, thus the consumer will see only a trivial price impact. At the other extreme would be an *excise tax on goods produced by a competitive industry* where prices equal variable costs plus a normal return on capital: here the tax must eventually be fully passed on to consumers.

2. Whether close substitutes to the taxed item exist and, equally important, whether production of these substitutes can be increased without price increases for them. If close substitutes exist, demand for them will rise. If their production cannot increase, the prices will rise as much as that of the taxed commodity *but* the government will not collect any revenue form these increases. An obvious conclusion is that taxes are best—most efficient in raising revenue and avoiding distortion of choices--if they are broad-based, taxing an item and all of its close substitutes.

3. Whether the tax is levied early or late in the chain of production, wholesale and retail distribution. A tax levied only on the final retail sales will be less likely to be subject to additional markups by distributors covering the cost of carrying higher-priced inventories or following traditional percentage markup rules.

Table 1
Inflation Impacts of Alternative Taxes

	Excise Taxes				Income Tax
	Beer	Oil Import	Gasoline	General Sales	Surcharge
Expected Price Increases					
- Taxed Item	Yes	Yes	Yes	Yes	Limited
- Close Substitutes	Yes	Yes	No	Limited	No
- Additional Wholesale/ Retail Markups	Yes	Yes	Limited	No	No
Conclusion: Aggregate Direct Inflation Impact	Large	Very Large	Medium	Medium	Small

Table 1 (Inflation Impacts of Alternative Taxes) applies these principals of tax-inflation relationships to three excise tax increases currently under consideration and, as a contrast, two broad-based tax alternatives.

- From an inflation perspective, the worst possible tax is an oil import fee. First, OPEC pre-tax prices cannot be expected to decline to absorb any of the tax. Second, only a fraction of the resultant price increases for all energy products would flow to federal government as tax revenue. The government would collect the full price increase on imported oil, while other energy price increases (domestic oil, gas, possibly coal) would just transfer income from consumers to producers (without generating tax dollars) and would significantly raise inflation.

- A gasoline tax is a much preferable energy tax because the direct inflation side effects would be much smaller—the tax is levied at the final retail sale and there are no close substitutes (assuming diesel fuel is also taxed). But, as is shown later, this tax is also almost powerless to close the deficit.

- A beer tax falls qualitatively between these two energy taxes. Beer sales are intensely competitive, suggesting little room for producers to absorb the tax. Second, wine and liquor are close substitutes, thus their prices will either rise (untaxed) or the falloff in beer industry sales could be dramatic. Finally, the industry argues that the use of fixed percentage markups is an entrenched practice, thus levying the tax at the wholesale level will lead to exaggerated retail beer price increases (again untaxed).

- A general sales tax is far more preferable: all substitutes (except saving!) are, by definition, taxed and it's paid only at final retail level. A tax on all forms of alcoholic beverage consumption, or on all entertainment expenses would logically fit in the middle of a spectrum from a beer excise to a general sales tax.

- An income tax increase, as noted earlier, is clearly the best tax alternative because the direct inflation consequences would be virtually nil.

Table 2
Macroeconomic and Budget Impacts: Alternative Energy Taxes
(Changes relative to base case)

	1987		1988		1989	
	Oil Import Fee	Gas Tax	Oil Import Fee	Gas Tax	Oil Import Fee	Gas Tax
Macroeconomic Impacts						
Consumer Prices (%)	1.0	0.5	1.5	0.5	1.7	0.5
Treasury Bond Rate (% point)	0.05	-0.03	0.15	-0.05	0.09	-0.08
Real GNP (%)	-0.2	-0.3	-0.8	-0.5	-1.3	-0.6
Real Fixed Investment (%)	0.0	-0.4	-0.9	-0.9	-2.4	-1.0
Employment (1000's)	-87	-129	-418	-309	-902	-410
Federal Budget Impacts ($ Billions)						
Energy Tax Levy	10.8	22.7	10.5	23.0	11.4	23.3
Other Revenues	6.9	-15.5	1.5	-18.9	-4.0	-19.1
Total Revenues	17.7	7.2	12.0	4.1	7.4	4.2
Interest Expense	0.5	0.2	1.4	0.1	2.4	-0.1
Other Govt. Spending	5.6	2.3	10.7	3.6	14.4	3.9
Total Spending	6.0	2.5	12.1	3.7	16.7	3.7
Deficit	-11.6	-4.7	0.1	-0.3	9.3	-0.5

Table 4
Effects of a 10 Cent per Barrel Gasoline Tax

	Changes Relative to Base Case				
	1987	1988	1989	1990	1991
	(Billions of Dollars)				
Energy Tax Levy	11	11	12	12	12
Consumers Energy Bill	5	5	4	4	4
Price Effects					
	(Percentage Change)				
Crude Oil Acquistion Price	0.1	0.3	0.3	0.3	0.2
(Dollars per Barrel)	0	0	0	0	0
Retail Gasoline Price	9.1	8.1	7.9	7.3	6.7
(Cents per Gallon)	9	8	8	8	8
Producer Prices					
Fuels,Related Products & Power	1.8	1.8	1.6	1.5	1.3
Refined Petroleum Products	4.3	3.9	3.5	3.2	2.8
Gas Fuels	0.0	0.2	0.2	0.2	0.2
Coal	0.1	0.1	0.1	0.1	0.0
Electric Power	0.1	0.2	0.2	0.2	0.1
Industrial Commodities	0.4	0.4	0.3	0.2	0.1
Consumer Price Index	0.5	0.5	0.5	0.4	0.3
Consumer Energy Prices	4.2	3.8	3.7	3.4	3.1
Macroeconomic Impacts					
Real GNP (Billions of 1982 Dollars)	-11	-20	-22	-18	-15
	(Percentage Change)				
Real GNP	-0.3	-0.5	-0.6	-0.4	-0.4
Consumption	-0.4	-0.6	-0.7	-0.6	-0.6
Energy	-1.4	-1.4	-1.5	-1.5	-1.4
Residential Investment	-0.5	-0.5	-0.3	0.2	0.5
Business Fixed Investment	-0.4	-1.1	-1.3	-0.9	-0.5
Exports	-0.1	-0.4	-0.6	-0.5	-0.4
Imports	-0.7	-1.3	-1.5	-1.2	-1.1
Real Disposable Income	-0.3	-0.5	-0.6	-0.6	-0.6
Industrial Production	-0.6	-1.0	-1.0	-0.7	-0.5
Treasury Bill Rate (Basis points)	6	2	-4	-9	-14
Housing Starts (Thousands of units)	-13	-11	-5	8	14
Employment	-0.1	-0.3	-0.4	-0.3	-0.3
(Thousands of Persons)	-129	-309	-410	-361	-293
Oil Imports (Billion Barrels)	-0.1	-0.1	-0.1	-0.1	-0.1
Current Account Balance (Billions of Dollars)	3	5	6	5	5
Government Budget Impacts					
Federal Government					
Offsetting Tax Changes	-4	-7	-7	-6	-7
Total Revenues	7	4	4	5	5
Expenditure Changes	2	4	4	2	-1
Federal Deficit	-5	0	0	-3	-5
State & Local Government Deficit	2	3	2	0	0
Total Government Deficit	-2	2	1	-3	-5

Table 3
Effects of a $5 per Barrel Oil Import Fee

	Changes Relative to Base Case				
	1987	1988	1989	1990	1991
	(Billions of Dollars)				
Energy Tax Levy	11	13	11	12	13
Consumers Energy Bill	11	14	14	13	11
Price Effects					
	(Percentage Change)				
Crude Oil Acquistion Price	29.8	28.4	27.0	25.0	22.7
(Dollars per Barrel)	5	5	5	5	5
Retail Gasoline Price	12.5	12.3	11.4	10.0	8.6
(Cents per Gallon)	12	12	12	11	10
Producer Prices					
Fuels,Related Products & Power	15.4	17.7	17.1	15.8	14.3
Refined Petroleum Products	21.6	23.0	21.4	19.2	17.1
Gas Fuels	18.6	22.2	20.7	18.5	16.5
Coal	1.6	4.4	6.6	6.7	6.0
Electric Power	2.8	6.1	7.2	7.4	6.7
Industrial Commodities	2.9	3.6	3.4	3.1	2.6
Consumer Price Index	1.0	1.5	1.7	1.7	1.5
Consumer Energy Prices	8.3	9.6	9.3	8.4	7.3
Macroeconomic Impacts					
Real GNP (Billions of 1982 Dollars)	-7	-29	-53	-51	-42
	(Percentage Change)				
Real GNP	-0.2	-0.8	-1.3	-1.3	-1.0
Consumption	-0.6	-1.0	-1.4	-1.3	-1.2
Energy	-2.2	-2.3	-2.3	-2.3	-2.3
Residential Investment	-1.0	-1.8	-2.3	-1.1	0.1
Business Fixed Investment	0.4	-0.6	-2.5	-2.7	-1.7
Exports	-0.2	-1.0	-2.2	-2.7	-2.6
Imports	-1.5	-2.5	-3.5	-3.7	-3.4
Real Disposable Income	-0.5	-0.8	-1.2	-1.3	-1.2
Industrial Production	-0.6	-2.2	-3.5	-3.4	-2.9
Treasury Bill Rate (Basis points)	17	28	22	9	-3
Housing Starts (Thousands of units)	-31	-54	-51	-14	18
Employment	-0.1	-0.4	-0.8	-0.9	-0.8
(Thousands of Persons)	-87	-418	-902	-1,002	-877
Oil Imports (Billion Barrels)	-0.2	-0.4	-0.5	-0.5	-0.6
Current Account Balance (Billions of Dollars)	7	10	10	7	6
Government Budget Impacts					
Federal Government					
Offsetting Tax Changes	7	2	-4	-3	-1
Total Revenues	18	12	7	9	12
Expenditure Changes	6	12	17	17	14
Federal Deficit	-12	0	9	8	2
State & Local Government Deficit	1	3	3	0	-2
Total Government Deficit	-11	3	13	8	0

Senator **Baucus**. Dr. Brinner, do you agree with Mr. Bosworth that about a $30 billion deficit reduction annually is in the range of what we should try to do?

Dr. **Brinner**. Yes, I do. $30 to $40 billion is certainly bearable by the economy.

Senator **Baucus**. Now, do you have any views as to the degree to which the mix ideally, from a macro point of view, should consist of revenue increases and spending cuts?

Dr. **Brinner**. I think that Congress has wisely hit on a number like $20 billion for the revenue component.

There is a set of graphs in my handout that show the shares of revenue and taxation as a percent of GNP; and it is clear that we do have a fairly flat trend of Federal revenues as a percent of GNP. 18 to 20 percent is the range since 1950.

An extra $20 billion would bring us back up to the top end of that range.

Senator **Baucus**. You would split it roughly 50/50. Is that right?

Dr. **Brinner**. Yes, I would split it approximately 50/50.

Senator **Baucus**. Mr. Bosworth, what do you think ideally? Does it make much difference to you whether it is 50/50?

Mr. **Bosworth**. From an economic point of view, it doesn't make any difference to me at all.

Senator **Baucus**. Or 25/75? Either way?

Mr. **Bosworth**. Yes.

Senator **Baucus**. It doesn't make much difference. Dr. Brinner, on the tax side, if we raise revenues, do you prefer a surcharge on individual income?

Dr. **Brinner**. Yes.

Senator **Baucus**. Mr. Bosworth, if we raise taxes, from a macro point of view, do you agree with Dr. Brinner?

Mr. **Bosworth**. I agree with him to the extent that any tax increase, I think, to increase revenue is better, the broader the tax and the broadest tax base we now have is the personal income tax.

I also think that some of these other taxes, which are proposed as though business is going to pay, or somebody else is going to pay, is an illusion.

I think taxpayers should realize that ultimately individuals pay all taxes in the United States, one way or another; and if you increase corporate taxes, they will just pass it through in the form of higher prices.

So, I would most prefer a personal income tax.

Senator **Baucus**. Your answer is a little curious to me because you have made a point in your testimony indicating the low savings rate we have for this country. It seems to me that a personal tax or a surcharge on individual income could further depress private savings rates in this country.

One could argue that an excise tax or a consumption tax——

Mr. **Bosworth**. I think there are two answers to that.

The national savings rate in the United States is low today, not because of any change whatsoever in private savings behavior.

The private savings rate has been a constant throughout the entire postwar period. It is low today because the Government savings rate is extremely negative.

This is not a decline in private savings that is responsible for this problem. It is a decline in Government savings, so to speak, or a much larger budget deficit.

Second, I very strongly believe that any effort to try to use the tax system to promote or discourage private savings isn't going to work. We have tried these experiments and spent billions of dollars trying to raise the private saying rate; and nothing happens.

Senator BAUCUS. If it is Government "dissavings," why do other countries—and one that comes to mind is Japan—have such high national savings rates? Japan has about the same proportional Federal dissavings rate as the United States does, but its national savings rate is much higher.

Mr. BOSWORTH. The private savings rate is highest in Japan among industrial countries and lowest basically in the United States, Great Britain, and Sweden.

The full reasons for that—I have never yet seen an economic study that can account for it.

But there is one thing on which I think we now agree. It is not due to differences in tax treatment between these countries.

If you go to Japan, I think you observe one of the reasons that the savings rate is higher in Japan. It is very hard to spend in that country. In particular, most Americans spend their money on a lot of housing; and it is just about impossible in Japan to spend your money that way.

Second, they do not have a credit system that allows people to borrow at young ages in order to accumulate homes and automobiles.

Therefore, there is a dramatic difference between the United States and Japan in the age profile of savings over time. We dissave enormously when we are young and hopefully save to pay off our debts when we are older.

In Japan, the pattern seems to be almost exactly the reverse of that. So, a lot of it can be traced, I think, to customs, to differences of financial arrangements, but mostly I just think the Japanese have historically been willing to save more than Americans.

Senator BAUCUS. I think you are absolutely right. I guess it is more cultural than anything else, but do you suggest we look at some way to discourage the availability of credit?

Mr. BOSWORTH. There may come a day when Government will have to push itself to find a way to raise the private savings rate. At the present time, it makes no sense to try to raise the private savings rate when the Government sits here borrowing two-thirds of it, anyway.

If you want to increase the national savings rate, there is a simple way to do it that every economist I know of agrees will do it. Reduce the size of the Federal budget deficit. It will increase national savings, almost dollar for dollar.

Senator BAUCUS. I wish you could go to the Oval Office.

[Laughter.]

I understand that every member of the Cabinet has gone to the President with that message—in groups and individually. And every time, the President has told the Cabinet that, no, he will not agree to a tax increase.

I would like you to accompany them the next time they go. Senator Rockefeller?

Senator ROCKEFELLER. You both mentioned that if you reduce the Federal deficit, that does not necessarily make an impact on the habits to be formed, perhaps over a decade or a generation of Americans. You can argue, as would I, that we have to reduce the Federal budget deficit; but on the other hand, if we do that, it doesn't necessarily tell the American people in their own individual cultural or other habits to save.

Now, I came in late, but I have always assumed that our lack of saving was the root of an awful lot of our problems, not only for capital investment formation but sort of a national will.

I will put it another way. How do you encourage teenagers who should be going to school—or who do go to school, but go to school sleepy because they have been up the previous night working at some fast food joint making amounts of money not to buy books, but to buy designer jeans? Now, that is cultural and serious.

And that has long-term implications quite apart from whether or not the Federal budget deficit decrease.

In the 1981 tax cut, as I understand it, it was meant to encourage personal saving and corporate investment; and it didn't do either one.

That had to be cultural and habitual, not just related to Federal patterns.

What, over the longer term, do you see other than Government signals? You, Mr. Bosworth, have ruled out—as I take it—incentives. You said we have tried spending billions of dollars on them, and they don't work.

I guess my question to you is: What does work? What can work other than prayers and crossed fingers and time to encourage Americans who clearly live off plastic cards and who clearly don't think about the future and clearly don't act until there is a crisis already five years past them?

I mean, aren't you meant to be in the business of guiding us more precisely than that?

Mr. BOSWORTH. I think there is a very easy answer to it. The objective is to have a high national savings rate. If it is provided through the private sector or through the public sector, it makes absolutely no difference.

The problem in this country has not, in my view, been that the private savings rate is that much too low. Most Americans do have a lot of debts; but if you will notice, by the time they die, they manage to pay them off.

I think if the nation wants a higher savings rate, which I believe has lots of benefits to future generations and to the current generation in terms of higher rates of capital formation, we just as a public goal say let's do it through the public sector.

Let's quit borrowing all the private savings to finance our own current consumption. If we want to change the national savings rate, just change the rules of the budget that we quit absorbing that small amount of savings that the private sector does do.

If you just had a zero budget deficit for example, the national savings rate in the United States would now be twice as high as it currently is.

I think that that would provide a lot of extra capital formation. Whether the opportunities for increased capital formation are so great in this country that we wanted to go beyond that, we could try to do it two ways.

We could say: Let's run a Government budget surplus, as a way to provide more national savings. Many other countries in the world, during their periods of high economic growth, used to do exactly that.

Or we could try to raise the private savings rate. The only thing I would say about the private savings rate is we have had an enormous number of experiments with taxes, trying to do it, various types of incentives. They failed because apparently most people in the United States save with a specific goal in mind: retirement. And that is it.

You don't change that goal of savings by changing the taxes. You change the method by which I do my savings. All the time you had IRA's, I never had a personal savings account, any more. I took all my money out of the savings account and moved it over to an IRA; but it didn't change my savings behavior.

I am not sure that Government right now should try to raise the private savings rate; but even more than that, I am not sure that I know a way to do it. But we don't have to; we have a negative Government savings rate.

So, why with a Government that is dissaving does it sit up here and agonize over a low private savings rate? It is not a problem right now. It would be a problem, once we eliminated the Government dissavings; but we are a long way from that.

I just think it is a false issue. It is a way to distract attention away from the fact that it is the Government that is dissaving in this economy.

Senator ROCKEFELLER. I want to hear from Dr. Brinner on that, too; but you know, we are still doing the trade bill, and I guess we will be doing that for years, but people would come in and say you have to concentrate on reducing the budget deficit. If you want to get rid of the trade deficit, you have to reduce the budget deficit.

Then, everybody said it was $170 billion, and really, if you opened up all the markets everywhere and everybody gave you free access, you would only reduce it by about $20 to $25 billion. So what you really ought to concentrate on is the Federal budget deficit.

But then culturally, the other side of that argument is that if you choose to treat $25 billion as not being significant because it isn't the majority of the $170 billion, and then don't act on that, then you also choose to treat those habits that create the $25 billion, which is partly from other countries—that is, their markets aren't open—but then probably from us because we declined to put our steering wheels on cars that we would try to sell to Japan on the right side rather than the left side of the car—we don't learn their languages, we don't try hard enough—all things the Japanese tell us ad nauseum as their barriers are up against us; but they also speak the truth.

In other words, one of the reasons you focus on opening up markets and you try to do Government things about that is to create expectation pressure on export instincts. I mean, exporters in this country have only had to export from California to Texas, the markets in this country. They haven't had to worry about the rest of the world.

So, we have not been as good at it traditionally. It has been a long slow process of change.

I am trying to make a parallel point with private savings. I am not saying it is as important as national savings; but I am saying it is important because there are 230 million people who aren't very good at it.

You say they do what they have to, but it appears that we are getting worse, rather than better, at saving.

Dr. **Brinner**. I think that to say we are not very good at savings is an overstatement because, although our personal savings rate is low, I think it is because we have provided for retirement quite handsomely. If you combine the private pension programs and Social Security, most individuals recognize that a large burden of providing for their retirement has been taken over by their company or by the Government.

That is not the case in other countries that have a higher savings rate. Barry's points about the availability of credit at early stages in your life, when your income is low but your asset accumulation needs are high, is also valid.

We have set up a very balanced system where credit is available to those who need it and where retirement is provided for. Therefore, we don't need to have an aggregate personal savings rate that is high.

So, I don't think that there is an outstanding need to set an example, as you were suggesting, in this case. I agree with your notion that, in other cases, having the Government set an example is very valuable.

But I just don't think that our private citizens are undersaving.

Senator **Rockefeller**. All right. Thank you.

Senator **Baucus**. Senator Packwood?

Senator **Packwood**. I missed the start, gentlemen, of your conversation. Define for me what you mean by "savings rate" before I ask more questions.

Dr. **Brinner**. The national savings rate is the sum of private and Government; and private itself is the sum of personal and corporate—household and corporate.

So, you do have to be careful, as your question suggests, what savings rate you are talking about.

Senator **Packwood**. When we see a figure that the United States has only a 3.5 percent savings rate, what does that figure mean?

Dr. **Brinner**. Now, that is the personal savings rate.

Senator **Packwood**. The private savings rate?

Dr. **Brinner**. No, that is personal—household. You see, our private is households plus business. Households save, and that is the rate you are thinking of—3.5 percent.

Businesses also retain earnings and they have depreciation allowances. Those are their savings.

Senator **Packwood**. All right. So, when we say 3.5 percent personal savings rate and Japan has a 20 percent savings rate, are we comparing apples to apples? Is that a personal savings rate?

Dr. **Brinner**. In that case, you are not. If you want to compare to Japan's 20 percent savings rate, you have to take our total private, which would be the household plus the business; and that number is something like 6 or 7 percent.

It is still much lower, but it is not the 3.5 versus 20; it is something like 7 percent versus 20 percent.

Mr. **Bosworth**. If you want to compare private savings rates in the United States—net savings by households plus corporations—put it together—I think you should always put them together because the reason the personal savings rate is so low in the United States historically is that there are a lot of advantages to putting your money in the corporate sector.

You know, don't pay the dividends to me because they get taxed. So, we get our savings through corporations.

Our rate is about 8 percent. It has been 8 percent for as long as we have had national accounts.

Senator **Packwood**. As long as we have had what?

Mr. **Bosworth**. National accounts. Going back before World War II.

Senator **Packwood**. And that counts personal and business?

Mr. **Bosworth**. Personal and business. And Japan's rate on that same basis is today about 15 percent.

Senator **Packwood**. All right.

Mr. **Bosworth**. It used to be about 20 percent. During the 1970s, it drifted down a little bit. They are becoming more like us maybe.

Senator **Packwood**. And our rate, counting personal and business, is still around 8 percent, you say today?

Mr. **Bosworth**. That is right. Yes.

Dr. **Brinner**. But the Government is now absorbing about 4.5 percent of GNP as a deficit, and that is the problem. That 8 percent that Barry talked about is not available for us to put into capital formation that we own.

Senator **Packwood**. And what the Government does with it does not do much to encourage growth?

Dr. **Brinner**. It discourages it. It displaces investment unless somebody else comes in to lend us the money.

Of course, if they—the Japanese or the British or the Germans—come in and lend the money, they own the capital either directly through equity or indirectly through bonds; and they are going to get the high returns in the future off of that capital. That is the problem.

Now, this argument gets played two ways. Someone will say: Actually, our investment to GNP ratio is high; therefore, the deficit is no problem, but they are ignoring the fact that to a certain extent we have been able to maintain our investment ratio because we have borrowed the money to make that investment. Somebody else is going to earn the return on that investment.

Senator **Packwood**. Let me take it a little further, and these are really questions of ignorance. Pacific Power and Light borrows some money and builds a dam as an investment helping the economy.

The Government borrows the money and builds a dam. That doesn't help the economy?

Dr. **Brinner**. No, that would help the economy. That is why in my remarks I said that you want to look at the expenditure by type.

If it is a capital improvement, either like you mentioned—a dam—or a human resource, if you improved education so that we were a smarter people, that is an investment that improves the national standard of living.

If you spend it on something that is not an investment like good——

Senator **Packwood**. Like what?

Dr. **Brinner**. National defense is not creating any ability to produce more goods and services. It is protecting what we have.

Senator **Packwood**. Let's back up a minute, though, because there the difference between the House figure and President Reagan's figure is around $14 to $15 billion in outlays.

That doesn't solve our budget problem, though. What does the Government spend on other than defense that really is utterly worthless?

Dr. **Brinner**. I wasn't saying utterly worthless. I am talking about investment versus current consumption.

Senator **Packwood**. All right.

Dr. **Brinner**. In current consumption, the Government is spending a lot on transfer payments for buying——

Senator **Packwood**. Social Security?

Dr. **Brinner**. Social Security, farm support.

Senator **Packwood**. Food stamps? There are many of the social welfare programs that are, by and large, maintenance programs.

Dr. **Brinner**. If it is not doing something to either improve our health, our knowledge, or the infrastructure of the country, then it is different from the Pacific Power dam situation.

Senator **Packwood**. Do you agree with that, Mr. Bosworth?

Mr. **Bosworth**. Yes, and I agree fully with you that it is very important not to talk just about the budget deficit and capital formation. There are lots of Government expenditure programs that do contribute to future productivity growth—education, dams, infrastructures, etcetera.

The trouble is that it is very hard to go very far with this sort of argument of breaking it down too far. Is Social Security absolutely worthless because it doesn't contribute to growth? No, I think you have to remember that there are lots of other objectives of Government besides just investment.

Senator **Packwood**. Besides just growth.

Mr. **Bosworth**. And you could argue that national defense, if you didn't have any, your investments might all become worthless in the future.

Senator **Packwood**. What I am curious about is should we be going in the following direction? Let's just for the moment put national defense aside, or assume we have the difference between the House and the President; and that is roughly where we are going to come out.

We will just say we have to have national defense; and if it doesn't promote as much growth as dams, we still have to have it. Are you then saying that there is a rule of thumb that we should be narrowing the Federal deficit—maybe it is by raising taxes or by cutting spending, but the spending we ought to be cutting is in the lesser productive ends which you might define as social welfare spending rather than education or the kind of spending that improves productivity—that that is the spending we ought to be cutting, narrowing the deficit, getting more out of the borrowing market, and letting that money go off into private purposes?

Dr. **Brinner**. Yes, and also you have touched on a related point. If you try and close the deficit simply through asset sales, that accomplishes nothing because all you are doing is absorbing private savings in a different way.

Senator **Packwood**. But I want to come back because I want to pursue this fundamental question we are talking about.

Absent defense, and in defense we are going to reach an agreement; and defense, considering the world's strongest left-wing dove that exists in Congress versus the strongest hawk, the diffenences are not that great in terms of what they are talking about.

If we roughly halve the difference, it still is not that great. It seems to me the only place we are going to get to where you say we ought to be going is increased taxes; but then, we have to take that out of the private sector, or cutting social spending.

Having already set defense aside, there might be some social spending like Social Security to which we would say, yes, there is a legitimate purpose other than productivity; but is that what you were saying?

If we set aside those things like Social Security and then get right down to the Medicaid, Medicare, food stamps, and the WIC Program and the WIN Program and say: These we are going to cut for the purpose of narrowing the deficit?

Dr. **Brinner**. I think you just have to take a little bit out of each of those programs.

Senator **Packwood**. Mr. Bosworth.

Mr. **Bosworth**. I don't think this is the story of being opposed to all types of consumption type public services. I think these programs are absolutely fine, and I don't believe a high level of welfare spending reduces economic growth in the United States, subject to one qualification.

If you are going to do it, you have got to pay for it. I don't believe there is this enormous difference among different types of Government expenditure programs, that this is good because it contributes to growth.

But the issue is from an economic prospective. You pay for what you get, period.

Senator **Packwood**. Yes.

Mr. **Bosworth**. What you spend it on is a political decision.

Senator **Packwood**. And you think what we spend it on, within reason, doesn't make that much difference?

Mr. **Bosworth**. Yes.

Senator **Packwood**. All right. Let's say we end up with $290 billion in outlays on defense this year. The President wants $312 billion, as I recall—maybe that is budget authority—but anyway, his critics win. And we need to pick up another—in our judgment—$30 or $40 billion in revenues because we are not going to particularly cut the spending.

What do we do that is the least harmful to the growth of the economy in picking up $30 to $40 billion in revenues?

Dr. BRINNER. What we argued this morning was that a personal income tax surcharge would be the least damaging. The alternative revenue increases—excise taxes—have an equal direct demand dampening effect on the economy; and the excise tax in addition directly raise inflation, raise interest rates because of that, cost the Federal Government more money because of the higher interest rates and the higher inflation, and end up not actually closing the deficit.

Senator PACKWOOD. And raising the income taxes will have no more deleterious effect on growth than raising the excise taxes?

Dr. BRINNER. The first round impact of income tax is the same. But it is the second round impact of excise taxes that are worse because of the inflation they generate.

No one argues that raising the income tax will add to inflation.

Senator BAUCUS. How many economists would agree with that proposition?

Dr. BRINNER. 99 percent.

Senator BAUCUS. 99 percent of economists would agree with that?

Dr. BRINNER. Yes.

Senator BAUCUS. That is, they would agree that when we raise revenue, the better way would be to——

Dr. BRINNER. Oh, I thought that you were asking if raising income tax rates would add to inflation. I am sorry.

Senator BAUCUS. I am trying to establish whether there is virtual agreement among economists that, if we raise revenue, the better way to raise it is with an income tax surcharge.

Dr. BRINNER. I think those who would support excise taxes would be looking for additional arguments, feeling that there is a syntax element involved and that it is good to suppress consumption of certain items because of future health costs or national security, in the case of oil, or subsidiary issues.

But if you are strictly talking about macroeconomic performance and inflation and growth, I think you could get a very broad concensus—75 percent or better—that would agree that raising the income tax is preferable to raising excise taxes.

Mr. BOSWORTH. I think the one where you can get very broad agreement among economists is that the broader the tax, the more they are going to like it.

Senator BAUCUS. The broader the tax——

Mr. BOSWORTH. The broader the tax, the better the tax because it has less chance of distorting economic behavior if all forms of behavior are faced with equal increases in tax.

You don't lead people to go substitute one crazy kind of tax for another.

Second, where you would get differences among economists is that some economists would not like to even run the risk of reducing savings. So, they would favor a consumption tax type of approach over an income tax.

So, you might get, say, more support for a value-added tax. Macroeconomists, like Roger, in particular I think would come back; the one problem they would have with that is that, in the short run, that is going to up the rate of inflation and, therefore, you are going to get some short-run negative effects from the inflation area.

Senator **Baucus**. All right. Let's say we agree with both of you that raising personal income taxes, from a macroeconomic point of view, is preferable to raising excise taxes; but all of us, as representatives of different constituencies, face other considerations as well. You alluded to one, that is, the potential adverse health effects of, say, cigarettes.

There is the argument for raising the cigarette tax to discourage cigarette consumption.

What is the degree of difference between personal income taxes and excise taxes? Is it major? Is it marginal?

Dr. **Brinner**. It is major regarding deficit reduction.

Senator **Baucus**. I am assuming we would raise them by the same amount.

Dr. **Brinner**. I agree. If you raise them by the same amount as the tax levy. For example, I said that you would get a little bit more than $10 billion from a 10 cent per gallon gasoline tax; you would get a little bit more than $10 billion from a $5.00 per barrel oil import fee.

So, you could combine those two and kind of combine the regional interests by doing that and get $20 billion.

On the other hand, you would get about $20 billion from a personal tax surcharge. So, $20 billion in each case as the direct impact before you let the economy respond.

My simulations show that that $20 billion income tax surcharge would flow through the bottom line. You would get a reduction in the deficit.

My simulations show that it would not flow through in the case of the excise tax increases because the extra inflation would so increase Government expenditures, the reduced growth would so slow down other receipts, that you would actually not get a deficit reduction out of it, which is the primary reason—I take it—this committee is now considering those taxes, not because of their health considerations, but because of the deficit reduction need.

Senator **Baucus**. So, you find that there is a significant difference?

Dr. **Brinner**. A very significant difference.

Senator **Baucus**. Do you agree, Mr. Bosworth?

Mr. **Bosworth**. I would find in my own weighting of these a smaller difference than Roger would. I agree that the inflation effect in the short run—if it is not accommodated by Federal Reserve monetary policy—must result in higher interest rates.

This is a long-term problem. I weight most the need to get down increased revenues in the long run. The problem he is talking about is for one year or two that the inflation rate is higher, but then it will begin to recede back down again. We would get this back in the long term.

Senator **Baucus**. Yes.

Mr. **Bosworth**. I see a small difference. I most want the reduction in the budget deficit. I agree that I would prefer to take it in an income tax; but I don't think excise taxes are that bad, particularly given one other argument, which is that excise taxes is the type of tax that has declined most in the United States over the last several decades.

Dr. **BRINNER**. But that is because we have reduced import tariffs to open up our markets.

Mr. **BOSWORTH**. It is also because a lot of these tax rates were per unit purchased, and they have not gone up in line with inflation. It is both forms of it.

I am in favor of seeing some increase in excise taxes on a long-term basis.

Senator **BAUCUS**. Gentlemen, thank you very much. I know you have come on short notice and you have taken time out from your work. We appreciate it very much. Thank you.

Dr. **BRINNER**. Thank you for the opportunity.

[Whereupon, at 11:49 a.m., the hearing was concluded.]

[By direction of the chairman the following communication was made a part of the hearing record:]

National Coordinating Committee for Multiemployer Plans

SUITE 603 • 815 SIXTEENTH STREET, N.W., WASHINGTON, D.C. 20006 • (202) 347-1461

July 15, 1987

TESTIMONY OF ROBERT A. GEORGINE, CHAIRMAN
NATIONAL COORDINATING COMMITTEE FOR
MULTIEMPLOYER PLANS

BEFORE THE SENATE FINANCE COMMITTEE
HEARINGS ON BUDGET RESOLUTION

1. Introduction. My name is Robert A. Georgine, and I am submitting this testimony in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee was organized, shortly after the passage of ERISA in 1974, to represent the interests of the more than eight million working men and women, and their families, who are covered by multiemployer plans. The Committee's affiliates include more than 170 pension funds, health and welfare funds, and related international unions.

The NCCMP and its affiliates are deeply concerned by the recent legislative trend toward (1) proposing elimination of tax incentives for essential employee benefit programs under the misnomer of "tax reform"; and (2) attacking federal budget deficits through the imposition of additional tax burdens on these essential programs. These crucial programs will be destroyed if this trend continues. We are thus alarmed and dismayed at the Description of Possible Options to Increase Revenues, Prepared for the Committee on Ways and Means by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means ("Description") which includes suggestions that could have an extremely harsh impact on employee benefit plans.

The benefits provided today through collective bargaining or pursuant to federal or state legislation are the hard-won product of years of struggle. These benefits are essential to the financial security and physical well-being of working men and women and their families, who could not otherwise afford them. They provide essential protection against illness, forced early retirement, unemployment, and other tragedies or contingencies that interrupt earning power. They provide income that permits retirees to live with dignity, and without burdensome dependence on the public sector.

Congress has long recognized the importance of these programs, and, through favorable tax treatment, has encouraged their growth and development. These modest tax incentives have resulted in the provision of essential benefits to a broad cross-section of employees, especially lower-paid workers. More than seventy-five percent of those accruing pension benefits in 1983 earned less than $20,000 per year. Eighty percent of those with employer-paid health insurance in 1985 earned less than $25,000 per year. Health insurance was then being provided to nearly 80 percent of all public and private workers, and term life insurance coverage was virtually universal. Thus, the vast majority of employee benefit recipients are lower and middle-income individuals, who rely on their employer-paid benefits for their own and their family's security.

Unfortunately, Congress has recently shown an inclination to deal with these essential programs on an ad hoc, piecemeal basis in the context of deficit reduction or so-called "tax reform." Continuation of this trend will produce not only an irrational crazy quilt of rules, but also the step-by-step destruction of our nation's carefully conceived employee benefits structure. We can't just keep piling complicated rule on top of complicated rule or adding bits and pieces of new taxation without careful consideration of the impact on employee benefits policy and goals.

Elimination of tax incentives for essential employee benefit programs does not constitute the closing of any "loophole," and does not serve any of the other goals generally advocated as "tax reform." Moreover, attempting to balance the federal budget by reducing or eliminating the favorable tax treatment supporting essential employee benefit programs so important to the physical and financial well-being of working Americans is fundamentally wrong. Employees who rely most heavily on essential employee benefit programs are those least able to afford increased tax burdens. What kind of country is it that proposes to balance the budget on the backs of our sick, our elderly and our working poor?

Taxing essential employee benefit programs is also counterproductive in the long run because federal budget deficits will actually be increased by the need to fund new and expanded government programs to replace private sector programs. These programs provide benefits that would otherwise have to be provided through government programs like Medicare, Social Security and federal and state unemployment. Subjecting these essential benefits to FICA and FUTA tax -- regressive taxes that fall most harshly on the lower-paid workers who rely most heavily on employee benefit programs would be even less defensible.

In our view, the correct course is simple: No additional taxes on essential employee benefit programs.

2. Excise Tax on Net Investment Income of Exempt Organizations. Particularly ill-advised would be adoption of the Description's revenue-raising suggestion for imposition of a five percent excise tax on the net investment income of all tax-exempt organizations, including employee welfare benefit trusts and pension and profit sharing trusts. We strongly urge you to reject this as a method of raising revenues.

Any tax on the income of employee welfare and pension funds will increase the cost to employers of providing these benefits and make it even more difficult for employee representatives to bargain for adequate health and welfare and retirement benefits. As discussed at length above, and as recognized in the Description, these organizations provide essential benefits that lessen the burdens of government and that otherwise would have to be financed out of tax revenues. Thus, their decline or destruction, due to short-sighted imposition of additional tax burdens, would not only deprive millions of working Americans and their families of vital benefits, but, in the long run, would actually increase budget deficits.

We note in this regard that if plans are taxed and continue to provide current benefit levels, employers would have to increase contributions to cover amounts plans pay as taxes. Since these additional contributions will themselves be tax deductible, even the short-term net revenue increase would be reduced by a percentage equal to the employer's tax bracket -- i.e., approximately one-third.

We also note that the Internal Revenue Code already insures that employers cannot intentionally make tax deductible contributions to fund pension plans beyond what is required to provide promised pension benefits. Where inadvertent actuarial error produces a surplus, any reversion to the employer is subject to an excise tax under current law, and, in fact, no reversion at all is allowed from a multiemployer plan. The Deficit Reduction Act of 1984 established complex rules imposing unrelated business taxable income tax on the reserves of welfare benefit plans to assure no potential for abusive prefunding and imposing a 100% tax on any assets reverting to the employer. Thus, employee welfare and pension benefit trusts are in a much different posture from certain other types of tax-exempt organizations, such as 501(c)(3) organizations, most of which are not generally subject to explicit contribution or reserve restrictions. Accordingly, if any tax were to be imposed on the net income of tax-exempt organizations, an exception should be provided for all employee benefit trusts.

3. Tax on Employer-Paid Health Care Benefits. The NCCMP and its affiliates are strongly opposed to any tax on employer-paid health care benefits, whether structured as a "cap," as a "floor," or otherwise.

If the direct cost of health insurance benefits increased from greater tax burdens, regardless of form, many younger and healthier workers, who feel least in need of such benefits, would likely drop out of plans. This also would be true of low-income workers who simply cannot afford the additional cost. As their participation ended, the cost for the remaining workers would increase and could eventually become prohibitive. Alternatively, the remaining workers might not be a sufficient percentage of the workforce to pass new nondiscrimination tests after 1989. The end result would likely be the destruction of many such plans. Even before this, a health care cap would prompt the elimination of such protections as preventive, dental, mental health, vision care, prescription drug plans, diagnostic programs and out-patient services.

This devastation would come about even more quickly in collectively bargained plans. In such plans, workers cannot opt out individually. The decision not to bargain for such benefits is made by the collective bargaining representative for the group. Thus, the younger workers may likely vote to terminate health benefit programs. These young workers are faced with tough economic choices. Their first priority will necessarily be to satisfy their most immediate perceived needs like housing, food, transportation, and utilities. Many of these workers, especially the lower paid workers, have little or no discretionary funds they can choose to allocate to a tax on health care benefits, let alone to the cost of the benefits themselves. This is particularly true in the current economic climate, when many employers are reducing wage packages. Faced with the alternative of accepting further reduced wages or eliminating taxable health benefit programs, many younger workers will feel that they simply cannot afford to pay for taxable health benefits they do not expect to need in the near future.

As a result, older workers and workers with health problems may lose the opportunity to obtain health care coverage through employer paid programs. The cost of providing medical benefits increases dramatically with increased age of covered workers. For example, the cost of providing medical benefits to workers age 44 and under is only 80% of the average cost of providing benefits to all employees. This percentage increases with age to 112.5% for employees age 50 to 54, 125% for employees age 55 to 59, and 160% for employees age 60 to 64. Thus, many of these workers will be uninsurable on an individual basis or will find it impossible to obtain health insurance coverage at affordable rates. Through no choice of their own, they will be forced to rely on government programs. And just as important, the different goals and needs of older versus younger workers are likely to put additional strains on collective bargaining if the government forces workers to make these choices. Those strains will make it more difficult for collectively bargained plans to obtain the funding they need to provide benefits which would otherwise be unavailable.

Without new or expanded government programs, families stricken by illness could be left with no means of obtaining basic health care. Private sector programs provide over $80 billion per year in essential health protection, for a tax expenditure of only about $18 billion. Without these private sector programs, the government could well be required to spend all of that $80 billion directly.

Both the "cap" and the "floor" would fall harshly on a broad cross-section of multiemployer plan participants. Several years ago, a national actuarial consulting firm conducted a study of the 494 multiemployer welfare plans on which it has complete data. That study estimated that nearly half of the 1.4 million participants in those plans would have had to pay additional tax, averaging more than $150, if a tax cap on coverage exceeding $175 per month for a family or $70 per month for an individual had been effective in 1984. The study projects that, by 1989, almost 375 -- over three-fourths -- of such plans, covering more than one million employees, would be over the "cap."

Lower-paid workers would be among those adversely affected by such a "cap." High health coverage costs in multiemployer plans are not necessarily linked to high income levels for covered employees. Low-paid workers are often covered by multiemployer health plans that provide them a comprehensive benefit safety-net. Per-employee costs may be high in a multiemployer plan, because the plans generally cover dependents, and many make benefits available for those working only erratically in the industry or actually laid off, for whom claims may be high and no contributions are being made.

Under the "cap," a participant's additional taxable income would be a function of the amount by which the cost of his benefit coverage exceeded the "cap." Those with benefit coverage far in excess of the "cap" would pay much more than those who exceeded the "cap" only slightly. Thus, in addition to hitting those with "comprehensive" coverage, the "cap" would discriminate against those living in high-cost areas where the same basic coverage is more expensive, as well as older groups, groups with retiree coverage, groups in declining industries, those that provide extended coverage to unemployed workers and their families, and others.

On the other hand, a tax "floor" of $25 per month for family coverage and $10 per month for individual coverage would likely affect all multiemployer plan participants. Thus, each participant with a family would have $300 in additional taxable income every year -- $120 per year for participants with individual coverage. The resulting individual tax liabilities would depend on the participant's tax bracket.

As with the "cap," there are problems of relative equity in taxing everyone on the same flat dollar amount of their employer-paid coverage. For example, $300 in additional taxable income might be considered more onerous for a low-wage earner, and would represent a larger percentage of the total benefits provided to those with less comprehensive benefit packages.

Both the "cap" and the "floor" would be particularly burdensome for retirees, unemployed people, surviving spouses and dependents, and others with extended coverage under an employer-paid plan. These people might have little other income from which to pay the tax, but it would hardly be fair to include the cost of retiree and other extended-coverage benefits in the costs on which active workers taxes are based.

We also note that some states require insured health plans to provide certain types of health benefit coverage and that federal legislation currently being considered by Congress would require most employers to provide health benefits to their employees. It would be unjust to require employees to have this coverage whether they want it or not and then tax them on any portion of the value of it.

The burdens for multiemployer plans in complying with a health care tax would be imposing. If withholding were required, it would likely have to be done by contributing employers. The plans themselves do not pay cash health benefits to participants from which they could withhold.

The contributing employers would not know enough about the participants' benefit eligibility and coverage to do withholding, and the paperwork necessary to give them this information would be overwhelming. Many employers know little more than the hourly rate at which they contribute to a multiemployer plan. They wouldn't know which of the employees actually have plan coverage, or what their benefits are. Plans would have to send each of their hundreds or thousands of employers weekly printouts showing a current list of covered employees, whether such employees have individual or family coverage, and the value of that coverage. This is an extraordinary amount of paperwork in light of the large number of employers contributing to multiemployer plans and the generally small size of contributing employers.

We assume that no one would seriously propose taxing employees on contributions without regard to whether the employees are eligible for plan coverage. In many cases, employer contributions are measured by the hours worked by all bargaining unit employees, with a minimum amount of covered work required for an employee to gain and keep eligibility. Thus, someone for whom a contribution is made would not necessarily have health coverage that could be called "income."

Moreover, many plans don't know that particular employees have satisfied eligibility requirements until several months after eligibility is attained. Plans have to wait until they receive monthly or quarterly contribution reports from employers, and analyze the data. Indeed, in some industries, there are so many casual workers that plans ordinarily don't make a determination with respect to eligibility until a claim is actually made.

Most multiemployer plans of any significant size either have experience-rated insurance contracts or are self-insured. In both cases, the plans don't know what the cost of health coverage for a particular year is until substantially after the end of that year. It would therefore be impossible for most multiemployer plans to provide up-to-date data on a weekly basis, making withholding by the employer very difficult, if not impossible.

The plan itself cannot substitute for the employers for withholding purposes, because it would not make cash payments to participants from which taxes could be withheld. These withholding burdens would be much worse for Social Security (FICA) and federal unemployment taxes (FUTA), because the applicability of these taxes depends on the total amount of income the employee has earned during the year -- information plans ordinarily do not have. This would be an even worse nightmare for FUTA tax which must be coordinated not only with amounts that have already been paid by employers, but also with multiple state offsets applicable in the various states in which a multiemployer plan operates.

An alternative to withholding would be to have employees compute and pay the tax at the end of the year However, this raises serious questions of equity, especially for lower-paid workers who may find it extremely difficult, if not impossible, to come up with money sufficient to pay the tax all at once at the end of the year.

Finally, both the tax "cap" and the tax "floor" could easily prove to be the proverbial camel's nose under the tent. If a tax "floor" were enacted, it would be easy to increase the "floor" in future years until the entire amount of all employer-paid health care coverage were taxed. Similarly, a health care "cap" could be lowered in future years. A larger percentage would be covered in any event unless the "cap" were raised each year to reflect increased coverage costs. (We have similar concerns with respect to any proposal to tax a flat percentage of every exempt organization's income.)

In short, we believe that taxing health care benefits would be unfair and largely unworkable under any type of proposal. These benefits serve crucial social purposes. Without them, there would be increased pressure for new and expanded government programs which would cost far more than the revenue collected through the taxation of private sector benefits. Thus, these essential benefits should continue to be encouraged, as they have in the past, through favorable tax treatment.

4. Repeal of Exclusion for Employer-Paid Group Term Life Insurance. The Description raises the possibility of repealing the current exclusion from employee income of up to $50,000 of employer-paid group term life insurance. We urge you to reject this possibility.

Employer-paid group term life insurance is essential to the financial security of millions of ordinary working people and their families, who could not otherwise afford such protection. These benefits protect dependents against financial deprivation resulting from a loss of income at the time of an employee's premature death. Term life insurance is provided by employers to most public and private workers. The vast majority of its recipients are lower- and middle-income individuals, who have planned their futures and their family's security based on this vital benefit.

The private sector employee life insurance program, like other essential employee benefits, is a good buy in terms of tax expenditures. Its destruction, which could result from curtailment of its favorable tax treatment, would create serious deprivation for workers and their families and would likely impose substantial additional pressures on federally funded or assisted welfare and other programs. Without assistance through new or expanded government programs, families stricken by the death of a breadwinner would be left with no means of obtaining basic necessities. Any short-term deficit reduction brought about by curtailment of the existing benefit program structure could thus be outweighed by the resulting, long-term demands for direct government expenditures.

In addition, the administrative burdens would be enormous, especially for multiemployer plans. Under current law, the cost of life insurance in excess of $50,000 is calculated under uniform tables prescribed by the IRS. Use of these tables requires knowledge of the age of an employee and the number of months during the year he worked. Because this would be virtually impossible for multiemployer plans, which generally do not have the necessary information, such plans provide benefits below the $50,000 exclusion limit. If all such insurance were subject to inclusion, plans could presumably have to provide this data to all participants. Further, such plans would have to send W-2's, which they do not now provide, to each employee at the end of the year. Especially for younger workers, the administrative costs involved could well exceed the tax on the benefit.

We also want to point out that the life insurance exclusion is as important to thousands of self-insured plans as it is to insured arrangements. For many years, collectively bargained employee welfare benefit plans have provided death benefits to participants and their beneficiaries through tax-exempt trusts. These trusts have historically been operated and financed in a manner comparable to group term life insurance arrangements.

Death benefits paid from such trusts have been regarded as excludable under Code section 101(a) from a recipient's income as amounts received under a life insurance contract. Ross v. Odom, 401 F.2d 464 (5th cir. 1968) Cf. Private Letter Ruling 7206209210A (June 20, 1972). This makes sense since, like life insurance contracts, these programs are formal, binding, and actuarially designed to provide the promised benefits.

5. Repeal of $5,000 Death Benefit Exclusion. We also urge you not to repeal the $5,000 death benefit exclusion. This is an extremely vital benefit which is necessary to assist the families of working Americans that are stricken by the loss of a breadwinner. This modest $5,000 amount is not enough to do more than provide funeral costs and basic sustenance temporarily while a family tries to make other arrangements for its support. It would be unconscionable to tax these modest amounts which are intended to tide over families trying to deal with a sudden financial crisis in a time of grief.

We note that this exclusion may be important to some self-funded welfare plans, as well as to unfunded, uninsured arrangements. There may be self-funded welfare plan arrangements that fail the Ross v. Odoms test described above because they are not operated and financed in a manner comparable to group term life insurance arrangements. Participants in these plans would also be hurt by a repeal of the exclusion.

On the other hand, the vast majority of self-funded death benefit plans satisfy the Ross v. Odoms test. These plans could be protected by retaining the life insurance exclusion discussed above.

If the death benefit exclusion were nonetheless repealed, legislative history must ensure the continued availability of the life insurance exclusion for plans satisfying the Ross v. Odoms test. We suggest that the following language be included in all reports on the provision:

> "The repeal of the $5,000 exclusion for employer-paid death benefits is not intended to restrict in any way the current exclusion as insurance proceeds available for death benefits paid from self-funded employer-paid welfare benefit plans. The Committee intends that death benefits paid to employees through a funded employee welfare benefit trust 'should continue to be regarded' as paid pursuant to a life insurance contract where the trust is operated and financed in a manner comparable to group term life insurance arrangements, under the principles of Ross v. Odom, 401 F.2d 464 (5th Cir. 1968)."

6. Securities Transfer Excise Tax. The Description raises as a possible revenue raising option a securities transfer excise tax of 0.5 or 1.0 percent

of value upon transfers of securities. As the Description notes, this would be a regressive tax to the extent it applies to employee pension and welfare benefit plans because a significant amount of wealth is invested by these plans on behalf of lower and middle income individuals. In addition, it would increase the costs to employers of funding these essential benefits, thus making it more difficult for employee representatives to bargain successfully for the basic benefits vital to the physical well-being and financial security of working Americans and their families. Any revenue increase obtained in this fashion would also be offset to some extent by the increased deductions for the increased employer contributions necessary to make up for the tax loss to the trusts.

7. Treatment of Loans from Qualified Plans as Distributions. The Description suggests treating all loans from qualified plans to participants as taxable distributions, except to the extent they represent a return of the employees' investment in the contract. This would have the practical effect of eliminating participant loans, as employees would have to pay tax on the amount borrowed (including, presumably, an extra 10% if the borrower is under 59½) and still pay the full amount back to the plan. Many multiemployer defined contribution plans have traditionally allowed employees to borrow from their own accounts. If that were not allowed, employee support for those plans would be weakened, perhaps to the point of curtailing or eliminating them. This would undercut the retirement security of all workers for whom these plans represent a needed supplement to their basic pensions.

In addition, certain types of participant loans should continue to be excluded from the loan/ distribution concept.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") introduced the rules treating certain loans from retirement plans as taxable distributions. The Conference Report on TEFRA provides that:

> Investments (including investments in residential mortgages), which are made in the ordinary course of an investment program will not be considered as loans, if the amount of the mortgage loan does not exceed the fair market value of the property purchased with the loan proceeds. An investment program exists, for example, when trustees determine that a specific percentage or amount of plan assets will be invested in residential mortgages under specified conditions.

This exception to TEFRA's rules was provided because Congress recognized that loan programs of this type serve important purposes and are not subject to the perceived abuses that may exist with other types of loans. Any bill affecting the treatment of plan loans as distributions should provide an exception for plan investment programs. In addition, any legislative history should emphasize that the statutory loan restrictions do not apply to adequately secured investments made in the ordinary course of an investment program, even if the plan participants are among the targeted market.

8. Other Alternatives. If taxes should be raised, they must be raised. Whether this increase should result from new excise taxes, from changes in the rates applicable to business or those applicable to individuals, or from other measures is beyond the scope of our expertise. We can say, however, that new taxes on essential employee benefits -- however appealing they may seem as hidden, "non-tax" revenue-raisers -- would be unfair, ineffective, and extremely bad social policy.

Revenue Raising Options Required Under the Fiscal Year 1988 Budget Resolution

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THURSDAY, JULY 16, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee was convened, pursuant to notice, at 10 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman) presiding.

Present: Senators Bentsen, Riegle, Rockefeller, Daschle, Packwood, and Chafee.

[The press release announcing the hearing follows:]

[Press Release No. H-56, July 7, 1987]

FINANCE COMMITTEE TO HOLD HEARING ON BUDGET RESOLUTION

WASHINGTON, DC.—Senator Lloyd Bentsen (D., Texas), Chairman of the Senate Finance Committee, announced today that a series of three hearings will be held to consider the committee's obligation for raising revenues as required under the budget resolution for fiscal year 1988.

"The budget resolution passed by the Congress instructs the Finance Committee to report legislation raising $19.3 billion in new revenues for fiscal year 1988. The hearings will enable the committee to examine all possible options for meeting its goal," Bentsen said.

The hearings will focus on all available revenue options, particularly those included in the Joint Tax Committee's staff pamphlet published on June 25, 1987.

The hearings are scheduled for Wednesday, Thursday and Friday, July 15, 16 and 17, 1987 at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The CHAIRMAN. This hearing will come to order.

Our first panel will consist of the following witnesses. Will you please come forward and take your places at the witness stand? Mr. Matthew Myers, Staff Director, Coalition on Smoking OR Health; Mr. Charles Whitley, Washington Representative of The Tobacco Institute; Ms. Christine Lubinski, Washington Representative of the National Council on Alcoholism; Mr. John Martini, Member of the Wine Grape Growers of America; and Mr. Douglas Metz, Executive Vice President and General Counsel, Wine and Spirits Wholesalers of America.

Let me state that the Senate was in session until approximately 1:00 a.m. this morning, and I think that is evidenced by what I see on my left and my right. And in addition to that, we have a delegation that is attending the ceremonies in Philadelphia on the anniversary of the Constitution.

So, we will not have as many members in attendance. That doesn't lessen the importance of these hearings.

And we have media coverage, so the public will be fully informed of them. In addition, we will develop a record that will be of importance to us as we try to make our determinations and judgments as to how we should fulfill the request of the Budget Committee in raising in excess of $60 billion.

Mr. Myers, we will let you start out first with your testimony. Mr. Myers, once again, represents the Coalition on Smoking OR Health.

STATEMENT OF MATTHEW L. MYERS, STAFF DIRECTOR, COALITION ON SMOKING OR HEALTH, WASHINGTON, DC

Mr. **Myers**. Mr. Chairman, I would ask that our full statement be put in the record, and I would like to briefly summarize our major points.

The **Chairman**. That will be done.

Mr. **Myers**. My name is Matthew Myers. I am here today representing the American Cancer Society, the American Heart Association, the American Lung Association, and their combined five million plus volunteers working through the Coalition on Smoking OR Health.

I also have the extreme pleasure to tell you that I am here representing a larger ad hoc group of some 49 additional national organizations ranging from the American Association of Retired People to the Children's Defense Fund to virtually every major health-related organization in this country.

We all agree on one critical point, that it makes sound tax policy and sound health policy to increase the excise tax on cigarettes; and that is the point I would like to address.

In my testimony this morning, I would like to discuss four issues briefly.

First, the impact of the cigarette excise tax on our nation's health and cigarette consumption. Second, the economic impact of the cigarette excise tax. Third, the fairness of the cigarette excise tax. And fourth and very briefly, the fact that today the tax burden on cigarettes is actually substantially lower than it has been at almost any time in the last 35 years.

The **Chairman**. How do you account for that? Give me some numbers to help us better understand what you are saying.

Mr. **Myers**. Certainly, sir. You want to start with that issue on the tax burden question?

The **Chairman**. That is fine.

Mr. **Myers**. That would be my pleasure. In 1951, when an eight cent cigarette excise tax was instituted, that excise tax represented 42 percent of the cost of a pack of cigarettes.

Since 1951, the Consumer Price Index has nearly quadrupled; but based on current cigarette prices, the recent extension of the 1982 tax brings up the Federal tax burden on a pack of cigarettes to only about 16 percent.

That means that as a percentage of GNP, Federal cigarette excise tax revenues have declined from .47 percent in 1951 to less than .13 percent now.

When you take a combined look at Federal and State taxes, you get the same picture. During the two decades from 1954 to 1973, the total State and Federal tax share of the retail price of a pack of cigarettes was never less than 46.6 percent.

The total share as of 1984 with the eight cent increase in 1982 stood at just 32.3 percent so that, even with the eight cent increase in 1982, which was permanently extended last year, the total tax burden has dropped by nearly one-third.

Thus, what we find today is that the overall tax burden on cigarettes when Federal, State and local taxes are computed, has been lower than it is today in only two years since 1951; and those were the years of 1981 and 1982, just before the Federal Government increased the tax by eight cents.

Now, let me focus if I may on the real reasons why we are so supportive of an excise tax increase. The one issue on which Mr. Whitley and I will probably agree is that increased cigarette excise taxes result in increased prices; increased prices result in decreased consumption.

The critical fact is: Who does it affect?

Today, virtually all new smokers are teenagers or younger. Ninety percent of the people who start smoking start when they are teens.

Sixty percent are hooked by the time they are 14. What that means is that, of the two million new smokers every year, around a million of them are 14 years old or younger. An increase in the cigarette excise tax will have the largest impact on precisely those people—those people in the process of experimenting with or deciding to smoke.

The economic data show repeatedly that roughly a 10 percent increase in the price of cigarettes will result in a 14 percent decrease in consumption rates among those kids. What it means, by and large, is that those kids won't start; and what that means is that we will have 800,000 fewer teenagers every year becoming hooked. And what that means in terms of our long-term health is just staggering.

The tax also makes good economic policy. OTA has estimated that cigarettes cost us $65 billion a year. The Federal health care cost is in excess of $4 billion a year.

In addition to that, there are substantial Federal lost productivity costs. Use of an increased cigarette excise tax will simply help us pay back some of that.

Now, I find it ironic that The Tobacco Institute is coming up here and talking about the excise tax being unfair. We are deeply concerned about the impact of an excise tax on poor people; but we think when you look in terms of overall fairness, we think there is no question that this tax makes sound policy.

It is ironic that The Tobacco Institute comes up here and talks about fairness when they are devoting their marketing efforts targetted at these same young people, at these same minority markets, trying to hook them on a product, which they know will cost them money in health care costs, will cost them lost job productivity, and most important will cost them their lives.

We think for those people, as well as for all Americans, an increase in the excise tax which will help encourage people not to start smoking is the most sensible thing that we can be doing.

The **Chairman**. Mr. Myers, we have a five-minute limitation on testimony, and we will go through all of the witnesses prior to questioning. Then, we will have some extended time for that.

Mr. **Myers**. That is fine. Thank you, sir.

The **Chairman**. Mr. Whitley is the next witness. He is a former Representative and is now the Washington Representative for The Tobacco Institute.

[The prepared statement of Mr. Myers follows:]

Statement

of the

American Cancer Society
American Heart Association,
and American Lung Association
as the Coalition on Smoking OR Health

on

Options to Increase Federal Revenues

before the

Senate Committee on Finance

July 16, 1987

The American Cancer Society, American Heart Association, and American Lung Association welcome this opportunity to testify before the Senate Committee on Finance on options to increase federal revenues as part of the effort to lower the federal deficit. Specifically, we urge this Committee to increase the federal cigarette excise tax.

Five years ago, our three organizations reached agreement that the serious health consequences related to cigarette smoking were of such concern that we should work as a coalition to seek enactment of a variety of legislative initiatives. From that agreement, the Coalition on Smoking OR Health was formed.

Today, at a time when 60 percent of smokers begin smoking by the age of 14, with 90 percent starting to smoke by age 19, tobacco use, especially among our nation's youth, remains a primary concern of each of our organizations. This year, over 300,000 Americans will die from smoking-related illnesses. Cigarette smoking will account for approximately 83 percent of all lung cancer deaths and 30 percent of all cancer deaths. An estimated 80 to 90 percent of all chronic obstructive lung diseases will be attributable to cigarette smoking. Likewise, a significant percentage of coronary heart disease deaths will be directly linked to smoking. In total, one out of every seven deaths in the United States will be smoking-related.

In an effort to discourage consumption, our organizations support a 16 cent increase in the federal cigarette excise tax, which is listed among the revenue options that the Committee will consider as part of its debate on budget reconciliation alternatives. A cigarette excise tax increase makes good sense from two perspectives. It is good health policy because it discourages the use of cigarettes. And it is good economic policy because it raises significant revenues.

The primary basis for our support of a cigarette excise tax increase is the important health benefits that we believe will necessarily accrue. Cigarette consumption is inversely related to price, i.e., as price increases demand decreases, particularly among young people who decide not to smoke at all. A 1986 analysis by Michigan University economist Kenneth E. Warner, as well as a number of earlier studies, confirmed that "cigarette excise tax changes ultimately influence the health of smokers and nonsmokers."

More specifically, Warner's analysis revealed than an eight cent increase in the federal cigarette excise tax, from the current level of 16 cents to 24 cents, would encourage 1.8 million individuals to quit or not start smoking. He found the effect greatest among teenagers. Thus, Professor Warner found that more than 400,000 teenagers and more than 500,000 young adults aged 20 to 25 years would quit or not start smoking as the result of an eight cent increase in the federal cigarette excise tax.

Doubling the federal cigarette excise tax, as proposed in the Committee's revenue options list, yields even more impressive results. According to Warner, "a 16 cent increase in the excise tax would encourage almost 3.5

million Americans to forego smoking habits in which they would engage if the tax were to remain at 16 cents per pack. This figure includes more than 800,000 teenagers and almost 2 million young adults aged 20 to 35 years." Professor Warner concluded that the proposed doubling of the federal cigarette excise tax would diminish the teenage smoking population by 17 percent.

A strong argument also exists that an increase in the cigarette excise tax is justified by the economic burden that cigarette smoking now imposes on society, in general, and on the federal government, in particular. A major analysis completed by the Office of Technology Assessment (OTA) in 1985, concluded that our nation incurs an estimated $65 billion annually in smoking-related health care and lost productivity costs. Smoking-related health care costs alone were estimated at $22 billion annually, or approximately six percent of Gross National Product (GNP). An estimated 75 percent of these costs were believed to be incurred by those under age 65. Annual lost productivity costs, including smoking-related absenteeism and disability were estimated at $43 billion.

Many of these smoking-related costs are borne by the federal government. According to OTA, annual federal government smoking-related health care outlays include $4.2 billion in Medicare and Medicaid payments. Other federal government outlays include $210 million through the Department of Defense and $400 million by the Veterans Administration. These estimates are conservative. OTA only considered government program cost estimates for persons aged 65 and over. The analysis did not take into account the previously-mentioned statistic, that 75 percent of smoking-related health care costs are incurred by those under the age of 65. Indeed, other analyses have suggested that the federal government's health care costs may well exceed $6 billion annually.

The OTA analysis supports the conclusion that cigarette smoking directly contributes to our nation's federal deficit. We believe that those who smoke should bear some responsibility for these increased costs. In this sense, the cigarette excise tax is like a "user fee".

However, some would argue that it is unfair to balance the burden of the nation's federal deficit on the backs of our nation's smokers, many of whom are considered middle and lower income Americans. Some express concern with the potential regressive nature of a cigarette excise tax increase, i.e., that any increase would consume a larger portion of the income of middle and lower income Americans than would be experienced by wealthier individuals.

We are extremely concerned about and sensitive to the impact of this tax on the poor. Nonetheless, we believe that among all the possible excise taxes this is the fairest and most justified.

First, it is cigarette smoking itself that has the greatest negative impact on the poor because it is the poor who are least able to afford the health care needed to cope with smoking-related disease. It is ironic that on this issue representatives of the tobacco industry express great concern for the poor while their advertising and marketing shamelessly is increasingly targeted at the poor in an effort to manipulate their attitudes to encourage them to smoke more. Interestingly, while the tobacco industry has been extremely vocal in its concern regarding regressivity, the industry's three most recent price increases over the past 12 months have caused the wholesale price of a carton of cigarettes to increase by nearly 16 percent.

Second, an increase in the cigarette excise tax will ensure that those who smoke will pay the federal government a greater proportion of the Medicare, Medicaid and other federal health care expenses that are directly tied to cigarette-related disease. In these days of fiscal restraint, it is no longer fair to ask those less advantaged Americans who have chosen not to smoke to bear the health care related financial burden of those who have chosen to smoke.

Third, even a 16 cent increase in the federal cigarette excise tax would not quite bring the tax to the level it would have been had the tax been adjusted for inflation since 1951.

Fourth, while any increased tax burden is difficult for the poor, the proposed 16 cent increase in the federal cigarette excise tax amounts to a smaller increase per person than most people realize. The average one-pack-per-day cigarette smoker already spends approximately $400 on cigarettes per year. An increase in the cigarette excise tax would result in the average cigarette smoker paying slightly more than $1 per week in higher cigarette prices. This sum is even less for poorer smokers because the data consistently show that while more poor people smoke, they each smoke substantially fewer cigarettes per day than the average smoker.

Finally, cigarettes are unique among the products on which excise taxes may be imposed. We recognize the unfairness in imposing increased excise taxes on items like gasoline or telephone usage, both of which have become near essentials in our society. Cigarettes are not an essential. Instead, they are a product that when used as intended will often result in severe disability, and all too frequently, death.

Some argue that tax policy should not be an instrument of social policy. They argue that it is irrelevant that an increased cigarette excise taxes will save lives by discouraging people from smoking. The reality is that virtually all taxes either affect people's behavior or have a disproportionate impact. Thus, at least it makes sense to recognize the impact and adopt a tax whose effect on behavior will be positive.

For these reasons, the American Cancer Society, American Heart Association, and American Lung Association urge enactment of a 16 cent increase in the federal cigarette excise tax.

STATEMENT OF CHARLES O. WHITLEY, WASHINGTON REPRESENTATIVE, THE TOBACCO INSTITUTE WASHINGTON, DC

Mr. **Whitley**. Thank you, Mr. Chairman. Like Mr. Myers, I have a printed statement which I should like to submit for the record in its entirety, and I will summarize.

The **Chairman**. It will be in its entirety.

Mr. **Whitley**. The first point I want to make to you is that a CBO staff study directed by Senator Mitchell of the Budget Committee reviewed a number of tax proposals under consideration and concluded that, of all those proposals, the excise taxes were the most regressive; and of the excise taxes, the cigarette taxes were the most regressive of all.

And we think that it is sort of ironic that in the last Congress we overhauled the tax laws, and you Senators and your colleagues did an excellent job of making sure that those adjustments were fair to all classes of taxpayers.

We think it would be inequitable now to go back and take away some of that gain from the lowest income taxpayers in the form of excise taxes, and general cigarette taxes in particular.

Second, despite what Mr. Myers has said about the tax on cigarettes not being sufficient and not being equitable, cigarettes are the only commodity—the only commodity—that have had the Federal excise tax doubled in the last five years.

They are the most taxed commodity from the standpoint of excise taxes at the State and local levels. Today, the average tax nationwide on a package of 20 cigarettes is 38 cents per pack.

Cigarettes today are the most—the most—taxed commodity in our nation.

Now, it has been said that a regressive tax on cigarettes is not regressive because cigarettes are not a necessity, that low income people could refrain from smoking cigarettes and, therefore, wouldn't pay the tax.

But excise taxes on items like cookies and candy and soft drinks would be no less regressive because you could make the argument that low income families can get along without those things; and the same thing applies to cigarette taxes.

Now, Mr. Myers makes the argument that if we increase the taxes on cigarettes, it would reduce the number of teenagers who begin to smoke or continue to smoke.

Mr. Chairman, that statement is sheer conjecture, which not only defies logic but flies in the face of a large body of empirical evidence. I don't think that any of us believes that the typical American teenager who thinks nothing of spending $10.00 on a music tape or $40.00 to $45.00 or more on Rebok or Air Jordon shoes is going to let his or her decision on whether or not to smoke depend on whether than pack of cigarettes cost $1.10 or $1.26.

That totally defies logic. In addition, there has been a large number of studies done and there is a great body of survey research done both in this country and in a number of European countries which over and over and over show very clearly that the decision of teenagers to smoke or not smoke is influenced far more by peer influence, by the habits of parents, siblings, members of the household, and other cultural elements and that price is not a significant factor in determining whether or not teenagers smoke.

Mr. Myers also talks about social cost to society. If costs are placed on society by the number of smokers smoking, you have to make a number of assumptions, which we don't have time to argue in depth here.

But even if you were willing to make those assumptions, then we contend that whatever cost that may be associated with smoking is borne by the smoker and not by society.

But even if you go further than that and accept Mr. Myers' hypothesis that there is a burden or a cost—an economic, quantifiable dollar cost—placed on society, the only one he really mentions or stresses is the Federally paid Medicare or Medicaid—medical type costs—which he quantifies at something like $4.8 billion.

Cigarette smokers are now paying in the form of Federal excise tax $4.7 billion. So, even if you take his numbers for the Federal cost, the smokers are paying that Federal cost.

I would like to point out, too, that when this committee and the Congress in its wisdom overhauled the Tax Code in the last Congress, one of the things and one of the major goals was to remove from the tax laws those provisions that weren't designed as revenue raisers, but they were there to try to induce people to do or refrain from doing certain things.

Some people referred to them as "tax breaks." They were incentives or disincentives, things like the investment tax credit, accelerated depreciation, depletion reserve, capital gains treatment, IRAs, and the like.

Congress took those things out or substantially reduced them and concluded in 1986: Let's not use the Tax Code to try to control or induce conduct, but instead let's work for a fair tax and then let people make their own choices.

Mr. Myers is not trying to pay costs. Mr. Myers is frank is saying he wants to make people stop smoking, and he wants to use the Internal Revenue Code to try to accomplish that goal.

If it was fair in the last Congress to use the Tax Code to raise revenues, and not to try to control or induce conduct, that remains a very valid principle and a very valid precept today. And I thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Whitley.

Our next witness will be Mr. Metz, who is the Executive Vice President and General Counsel of the Wine and Spirits Wholesalers of America.

[The prepared written statement of Mr. Whitley follows:]

TESTIMONY OF
CHARLES O. WHITLEY
ON BEHALF OF
THE TOBACCO INSTITUTE
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
JULY 9, 1987

Mr. Chairman, distinguished members of the Committee and former colleagues. I appreciate the opportunity to appear before you today to address the issue of a possible increase in the federal excise tax on tobacco products.

The list of revenue options prepared by the Joint Committee on Taxation (JCT) and the committee staff includes several proposals for increasing the tobacco excise tax, and I would like to address the arguments listed in the proposal in support of any increase.

The JCT print states that the most recent increase in the federal excise tax on tobacco occurred in 1982 and that had the tax been indexed to the CPI since its inception in 1951, it would be approximately 34¢ per pack today.

The most recent increase in the tobacco excise tax occurred on April 7, 1986 when the President signed the FY 1987 reconciliation bill. That legislation made permanent the 16¢ per pack level which was scheduled to expire on September 30, 1985 in accordance with the sunset provisions enacted in 1982 when the tax was temporarily increased from 8¢ to 16¢ per pack.

In any event, the argument in support of indexing this excise tax to the CPI is totally without merit. In the first place, the argument fails to acknowledge, much less address, the authority which has been actively utilized by state and local governments to impose similar excise taxes on tobacco products. In addition to the federal tax of 16¢ per pack on cigarettes, each state and 388 localities impose some form of excise tax on tobacco products. A list of the current levels of excise tax imposed by each state is attached. The average state and local tax is 22¢ per pack. Combined with the federal tax, the average total tax on tobacco products is 38¢ per pack. The Joint Committee print suggests that an indexing since 1951 would place the current tax level at 34¢ per pack. If the entire realm of taxation is reviewed, as it should be in addressing this question, it is apparent that the tax burden on tobacco has exceeded the level of inflation since 1951.

More fundamentally, I know of no logical reason for indexing the tax on this or any other product in order to keep pace with inflation. In fact, indexing taxes to inflation, simply assures more inflation, certainly not a desirable economic goal. The Committee print refers to retaining "the real tax burden of these taxes". Individuals who choose to purchase tobacco products experience a "real tax burden" each time they buy the product. Each year, approximately $10 billion in excise taxes is paid by the consumers of tobacco products. Approximately half of this amount is paid to the federal government. This is $10 billion over and above the personal income tax and other taxes paid by these consumers to the federal and state governments.

Furthermore, history shows that when the federal government increases the level of excise tax on this product, many states, anticipating a decline in sales, immediately enact similar increases in order to maintain existing levels of revenue from these taxes. This year, approximately 35 states have or will consider legislation increasing the excise tax on tobacco products.

A list of the states and respective proposals is attached. If the federal government increases taxes on tobacco products, it must do so with the knowledge that the tax burden for consumers will, more likely than not, be similarly increased at the state and local level as well.

The next argument in support of an increase offered by the Committee print is that despite the regressive nature of an excise tax, purchase of tobacco products by an individual is discretionary and, as such, lessens the regressive impact of the tax. In January of this year, the Congressional Budget Office, at the request of Senator George Mitchell, examined the distributional effects of an increase in selected federal excise taxes. The study looked at separate increases in the excise tax on seven commodities: beer, wine, liquor, tobacco, gasoline, airfare, and telephone service. Lest there be any doubt as to the regressivity of excise taxes in general and specifically the tax on tobacco, I quote the conclusion reached by CBO:

> "An increase in the excise tax on tobacco would be the most regressive of all the tax increases considered."

My experience as a member of the House and as a private citizen is that a tax is a tax, regardless of how it is imposed or on what product it is placed. Is a sales tax on food items such as cookies or candy any less regressive because it could be classified as a "discretionary item?". I do not think the purchaser of the product would think it is less regressive. In attempting to make the distinction between what is necessary and what is discretionary, we risk crossing the fine line between the right to choose in a free market and government regulation of individual behavior. An individual who has made an informed choice on whether to purchase a product should not be penalized with an additional tax burden because of his choice.

The Joint Committee print also states that an increase in the excise tax could be used to offset costs of administering programs of the Bureau of Alcohol, Tobacco, and Firearms. The current revenue from the tobacco excise tax, approximately $5 billion, goes to the general revenue fund of the treasury and is then disbursed through the normal appropriation process of Congress. This committee has been hesitant, and rightfully so, to earmark portions of existing excise taxes. Given the mandate under the budget resolution of increasing revenue to reduce the federal deficit, I would suggest that implementing a new earmarking of this tax would make that task even more difficult.

In the most recent reconciliation law, the time allowed for electronic transfer of excise taxes for tobacco products was decreased, thus allowing the government to realize additional funds from longer interest periods. This change, in addition to the tobacco manufacturers' exemplary tax compliance record, offsets any arguments in support of an increase to pay for the administration costs of the bureau.

I now turn to several points not readily apparent to committee members, but ones which should be considered. The Third District of North Carolina, which I was priviledged to represent, produces more tobacco than any other congressional district in the country. Absent each of you visiting the district for an extended period of time, it is impossible to convey the economic importance of tobacco to that area and the entire state. For some, tobacco is a controversial and sometimes an emotional issue. Regardless, it remains an issue which impacts hardworking Americans.

Tobacco growers and manufacturers have learned to work together to address current and potential problems in order to maintain this viable segment of American agriculture. The result of this work is a strong, yet somewhat delicate, program which would be disrupted by an increase in the federal excise tax on tobacco.

In addition to reducing the deficit, this committee is concerned with the American trade situation. Within the past two years, growers and manufacturers have addressed their own trade problems. The tobacco farmers have agreed to several major changes in the tobacco program including a significant decrease in price making their product more competitive in both the domestic and international markets. Manufacturers have agreed to purchase surplus American tobacco stocks and individual manufacturers have voluntarily agreed to decrease purchases of imported tobacco for use in domestic products.

An increase in the excise tax could negate the economic benefit of these actions. The tobacco industry currently contributes $2.7 billion to the positive side of the U.S. trade. I do not believe we can afford to enact legislation which penalizes a segment of our economy which is taking voluntary action to address its own concerns.

I can state without hesitation or doubt that next to the consumer, the American tobacco farmer will suffer most from such legislation. Tobacco is a cash crop in the truest sense of the word. It is good business practice for a farmer in some geographic regions to grow tobacco. In many instances, the production of tobacco enables the farmer to finance other operations on his farm. An increase in the excise tax will result in less tobacco being produced and sold by the American farmer. There are no acceptable alternatives for most tobacco farmers to make up for the loss in income. This, of course will have a ripple, if not wave, effect in communities throughout the southeastern United States which depend on this commodity as their economic backbone.

Congress is faced with tremendous problems in attempting to keep American agriculture viable. Tobacco production is a proud profession and one which has shown the ability to deal with its own problems. The dilemma facing the American farmer will be accelerated if this committee increases the excise tax on tobacco products.

In conclusion, I refer the committee to the final paragraph of the June 24th editorial of The Boston Globe:

> "The pressure to find more revenues should not blind Congress to a central objective of tax policy: fairness based on ability to pay. Relying too heavily on excise taxes betrays that aim."

STATE CIGARETTE EXCISE TAX RATES

(cents per 20-pack)

North Carolina	2
Virginia	2.5
Kentucky	3
South Carolina	7
Wyoming	8
California	10
Indiana	10.5
Georgia	12
Maryland	13
Missouri	13
Tennessee	13
Delaware	14
Ohio	14
Nevada	15
New Mexico	15
Arizona	15
Alaska	16
Louisiana	16
Montana	16
Alabama	16.5
New Hampshire	17
Vermont	17
Dist. of Columiba	17
West Virginia	17
Idaho	18
Mississippi	18
Oklahoma	18
Pennsylvania	18
Colorado	20
Illinois	20
Texas	20.5
Arkansas	21
Michigan	21
New York	21
Utah	23 [a]
South Dakota	23
Minnesota	23
Florida	24
Kansas	24
Rhode Island	25
New Jersey	25 [b]
Wisconsin	25
Massachusetts	26
Iowa	26
Connecticut	26
Nebraska	27 [c]
North Dakota	27 [d]
Oregon	27
Maine	28
Hawaii	29 [e]
Washington	31

[a] Rate includes 11 cent increase effective 4/27/87

[b] Includes surtax escalator; 19 cent excise + 6 percent surtax

[c] Rate includes 4 cent increase effective 7/1/87

[d] Rate includes 9 cent increase effective 7/1/87

[e] Rate is 40% of wholsale price

STATE LEGISLATION IN 1987 TO INCREASE EXCISE TAX ON TOBACCO PRODUCTS

State	Proposed change	Status
Alabama	+10¢	Pending
California	+25	Pending
Connecticut	+ 1 percent ad valorem	Rejected
Florida	+ 1	Rejected
Hawaii	+12	Rejected (Tax is ad valorem, so increases w/price)
Idaho	+8.9	Raised 8.9¢ eff. 4/1/87
Indiana	+ 5	Raised 5¢ eff. 7/1/87
Iowa	+10	Rejected
Massachusetts	+ 8	Pending
Michigan	+ 5	Rejected
Minnesota	+18	Raised 15¢ eff. 6/1/87
Mississippi	+ 1	Rejected
Missouri	+ 8	Rejected
Montana	+10	Rejected
Nebraska	+ 4	Raised 4¢ eff. 7/1/87
Nevada	+ 5	Raised 5¢ eff. 7/1/87-6/30/89
New Hampshire	+ 1	Rejected
New Jersey	+ 5	Pending
New York	+ 3	Pending
North Dakota	+ 9	Raised 9¢ eff. 7/1/87
Ohio	+ 5	Raised 5¢ eff. 7/15/87
Oklahoma	+ 5	Raised 5¢ eff. 6/1/87
Oregon	+10	Rejected
Pennsylvania	+ 2	Pending
South Carolina	+10	Rejected
South Dakota	+ 5	Rejected
Texas	+9.5	Pending
Utah	+11	Raised 11¢ eff. 4/27/87
Washington	replace with ad valorem	Rejected
West Virginia	replace with 28% ad valorem	Rejected
Wisconsin	+ 5	Pending

STATEMENT OF DOUGLAS W. METZ, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, WINE AND SPIRITS WHOLESALERS OF AMERICA, INC., WASHINGTON, DC

Mr. METZ. Thank you very much, Mr. Chairman. I ask that my testimony in its entirety be included in the record.

The CHAIRMAN. It will be taken in its entirety.

Mr. METZ. My association, which represents about 725 companies in all of the licensed States in the United States and in a little over half of those controlled States that permit the wholesaling of wine or spirits under license, joins with the rest of our industry in opposing any increase in the Federal taxes on alcoholic beverages.

We associate ourselves with our sister organization, The Distilled Spirits Council, in opposing several suggestions that would impact on the level of excise taxes on alcoholic beverages mentioned in the Joint Committee's Revenue Options pamphlet.

Mr. Chairman, our members are not giant companies. Half of our members have annual sales under $10 million, yet collectively we pay over $1.3 billion in State excise taxes.

Since 1951, the States have increased these taxes by over 700 percent. Wholesalers also pay a significant amount of Federal excise taxes. Since we directly import a majority of the wine and spirits entering the United States, we remit more than $300 million annually in Federal excise taxes and duties.

Last year we paid more than $100 million in the floor stock tax occasioned by the 1985 increase in the Federal excise tax on distilled spirits.

This escalating tax burden, combined with lifestyle changes in drinking habits, has resulted in the greatest economic crisis in our industry since repeal of prohibition.

For example, spirit sales have declined each year for the past six years. Table wine sales have declined by six percent in the last two years.

Industry employment continues to shrink—over five percent in 1986. In the last two years, our association membership has declined by 15 percent.

There is growing evidence that the taxation of the alcoholic beverage industry, amounting to over $12.5 billion in Federal, State, and local taxes has reached the saturation point.

Tax increases are not generating estimated revenues, and many States are actually experiencing revenue declines.

I think it is fitting in commemmorating our 200th anniversary of the United States Constitution to recall the words of Alexander Hamilton, who foresaw this problem when he warned in Federalist Paper No. 21, and I quote:

> Consumption taxes prescribe their own limit, which cannot be exceeded without defeating the end proposal—that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty that "in political arithmetic, two and two do not always make four."

> If duties are too high, they lessen the consumption, the collection is eluded; and the product to the Treasury is not as great as when they are confined within proper and moderate bounds.

It is time for the Congress to recognize that perpetuation of excise taxes at the Federal level is archaic—an unwise tax policy.

When Prohibition was repealed in 1934, the Federal Government depended on excise taxes for 46 percent of its revenue. Today, the number approximates four percent.

The Congress should accelerate the trend toward reliance on broad-based, nondiscriminatory taxes as revenue generators and leave selective excise and sales taxes to the States which depend on them for about 17 percent of their total income.

The regressive character of excise taxes offers another justification for their demise in Federal tax policy.

Products and services subject to these taxes cost low income consumers proportionately more than those with higher incomes. Three recent studies conducted by Congressional and outside groups confirm that excise tax increases can, depending on their magnitude, completely negate the savings for low income consumers from last year's tax reform.

The desired effect of those seeking higher prices as a way of tempering consumption by abusive drinkers and young drinkers is not to be realized.

When tax increases trigger price increases for alcoholic beverages, tens of millions of moderate drinkers cut back; but the problem drinker doesn't. Overall demand for alcoholic beverages falls, together with tax revenues; but the thirst of the alcoholic or the abusive drinker is not slaked.

Those consumers who drink moderately and who thus may benefit physically from modest consumption pay a price penalty.

Using tax increases to cure social ills like abusive consumption and the disease of alcoholism is a folly and has been documented.

Thus, the term "sin tax" is a cruel misnomer. The saints are punished, and the sinners are not deterred. The only sin is the Federal tax itself—regressive, unfairly discriminatory and punitive, and a debilitating encroachment on a source of revenue more vital to the States than to the Federal Government.

Mr. Chairman, one more chapter in tax reform needs to be written by this committee: the abolition of Federal excise taxes in favor of broader based and less discriminatory forms of business taxation. Thank you.

The CHAIRMAN. Thank you very much, Mr. Metz. Ms. Lubinski is the Washington Representative of the National Council on Alcoholism. Ms. Lubinski, we are pleased to have you with us.

[The prepared statement of Mr. Metz and a letter to Senator Riegle follow:]

Testimony on Behalf of the

WINE AND SPIRITS WHOLESALERS OF AMERICA, INC.

Mr. Chairman and Members of the Committee:

I am Douglas W. Metz, Executive Vice President and General Counsel, Wine and Spirits Wholesalers of America (WSWA). The 725 members of our association represent approximately 90 percent of the sales at wholesale of wines and spirits in the thirty-two license states, the District of Columbia, Puerto Rico and the Virgin Islands and in over half of the eighteen control states where wine can be wholesaled under license.

WSWA joins with the wine, spirits and beer industries in opposition to any increase in federal taxes on alcohol beverages. We also associate ourselves with the testimony of the Distilled Spirits Council of the United States against proposals in the Revenue Options pamphlet such as indexing, elimination of the deductibility of advertising expenses, and the taxation of "blenders" such as wine, and alcohol derived from flavors, at the rate for distilled spirits -- all of which would increase the present heavy tax burden on alcohol beverages.

TAXES ON ALCOHOL BEVERAGES CONTRIBUTE SIGNIFICANTLY TO FEDERAL, STATE AND LOCAL REVENUES

Mr. Chairman, our members are not giant companies. Half of our members have annual sales under $10 million. Yet, collectively we pay over $1.3 billion in state excise taxes. Since 1951, the states have increased these taxes by over 700%. Wholesalers also pay significant amounts of federal excise taxes. Since we directly import a majority of the bottled wines and spirits entering the U.S., we remit more than $300 million annually in federal excise taxes and duties. And last year we paid more than $100 million in the floor stock tax occasioned by the 1985 increase in the federal excise tax on distilled spirits.

This escalating tax burden, combined with lifestyle changes in drinking habits, have resulted in the greatest economic crisis in our industry since Repeal of Prohibition in 1934.

- Spirits sales have declined each year for the past six years. Table wine sales have declined by 6 percent in the last two years.
- Industry employment continues to shrink -- over 5 percent in 1986. In the last two years our association membership declined by 15 percent.

There is growing evidence that taxation of the alcohol beverage industry -- amounting to $12.5 billion in federal, state and local taxes -- has reached the saturation point. Tax increases are not generating estimated revenues; and many states are actually experiencing revenue declines.

Alexander Hamilton foresaw this when he warned in Federalist Paper No. 21:

> "Consumption taxes... prescribe their own limit, which cannot be exceeded without defeating the end proposal -- that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty that 'in political arithmetic two and two do not always make four'. If duties are too high, they lessen the consumption, the collection is eluded; and the product to the Treasury is not so great as when they are confined within proper and moderate bounds." (emphasis added)

It is time for the Congress to recognize that perpetuation of excise taxes at the federal level is archaic and unwise tax policy. When Prohibition was repealed in 1934, the federal government depended on excise taxes for 46 percent of its revenue. Today, that number approximates 4 percent. The Congress should accelerate the trend toward reliance on broad-based, non-discriminatory taxes as revenue generators and leave selective excise and sales taxes to the states, which depend on them for about 17 percent of their total income.

EXCISE TAXES ARE REGRESSIVE

The regressive character of excise taxes offers another justification for their demise in federal tax policy. Products and services subject to these taxes cost low income consumers proportionately more than those with higher incomes. Three recent studies conducted by Congressional and outside groups confirm that excise tax increases can, depending on their magnitude, completely negate the savings for low income consumers from last year's tax reform.

DESIRED SOCIAL CHANGE IS NOT APPARENT

The desired effect of those seeking higher prices as a way of tempering consumption by abusive drinkers and young drinkers is not to be realized.

When tax increases trigger price increases for alcohol beverages, tens of millions of moderate drinkers cut back, but the problem drinker doesn't. Overall demand for alcohol beverages falls, together with tax revenues, but the thirst of the alcoholic or abuser is not slaked. Those consumers who drink moderately and who thus may actually benefit physically from modest consumption pay a price penalty.

Using tax increases to cure social ills, like abusive consumption and the disease of alcoholism, is a folly and has been documented.

Thus, the term "sin tax" is a cruel misnomer. The "saints" are punished and the "sinners" are not deterred. The only "sin" is the federal tax itself -- regressive, unfairly discriminatory and punitive, and a debilitating encroachment on a source of revenue more vital to the states than the federal government.

Mr. Chairman, one more chapter in tax reform needs to be written by this Committee -- the abolition of federal excise taxes in favor of broader based and less discriminatory forms of business taxation.

# # #

WINE AND SPIRITS
W S
W A
WHOLESALERS OF AMERICA, INC.

EXECUTIVE OFFICES
1023 FIFTEENTH STREET, N.W.
FOURTH FLOOR
WASHINGTON, D.C. 20005-2602
202/371-WSWA

July 28, 1987

The Honorable Donald W. Riegle, Jr.
United States Senate
Washington, D.C. 20510-2201

Dear Senator Riegle:

At the Finance Committee hearings on excise tax increases and other revenue raising options held July 16, 1987, you asked me and other witnesses to provide you with information and statistics indicating the extent to which excise taxes have reached a level of diminishing returns.

Because time contraints prevented my response, I am supplying you and other members of the Finance Committee with information on this subject, as it relates to taxation of alcohol beverages.

The situation was summarized recently by Stephen E. Higgins, Director of the Bureau of Alcohol, Tobacco and Firearms. He noted that after the 19% federal excise tax (FET) increase on distilled spirits effective October 1, 1985, shipment of spirits dropped by 13% and that FET revenue rose only 3%. In 1984, the Committee on Finance estimated that this tax increase would produce $479 million in fiscal year 1986. In fact, the total increase in distilled spirits revenues for that period was $313 million -- or a shortfall of 35 percent.

At the state level, there are increasing reports that excise tax collections for alcohol beverages are declining. In its July 9 testimony before the House Ways and Means Committee, the National Conference of State Legislatures estimated that the states would lose $221 million if Congress raised federal excise taxes on alcohol beverages to levels proposed in the Joint Tax Committee's pamphlet on revenue options. Attachment A provides you with state-by-state breakout of projected revenue losses.

..../2..

There is a limit to how much tax our industry and its consumers can bear. Recent experience in other countries have demonstrated that punitive levels of spirits taxation can adversely affect public revenues which depend on steady or climbing consumption. In Australia, Canada, Denmark, Germany, Ireland, Japan, the Netherlands, and the United Kingdom, projected revenue gains from spirits tax hikes were far off the mark. In fact, revenues actually declined in Denmark following a 37.5% tax increase. In Ireland, the government saw revenues fall by some 20% following a series of tax hikes. As a result, Ireland reduced its spirits tax by 20% as of October, 1984.

We submit, therefore, that excise taxes on alcohol beverages in the United States have reached the saturation point. Further increases would lower state revenues, punish low income consumers, and aggravate tax discrimination against an already economically distressed industry.

Sincerely,

Douglas W. Metz
Executive Vice President/
General Counsel

DWM:ldg

Attachment

cc.: Committee on Finance
- Members
- Staff

National Conference of State Legislatures

STATE REVENUE LOSS RESULTING FROM INCREASED FEDERAL EXCISE TAX - ON ALCOHOLIC BEVERAGES

(In Thousands of Dollars)

STATE	DISTILLED ($2.00/gal.)	WINE ($.52/5th)	BEER ($.49/6 pk)	TOTAL
AL	2243.184	435.700	2095.350	4774.234
AK	246.344	81.000	234.181	561.525
AZ	1065.680	740.300	2031.078	3837.058
AR	493.679	110.400	818.479	1422.558
CA	6208.196	3708.350	7321.858	17238.404
CO	858.992	427.350	1124.842	2411.185
CT	1624.772	871.450	1659.165	4155.388
DE	117.018	32.350	45.979	195.347
DC	611.958	339.700	491.063	1442.721
FL	6716.465	4253.350	11161.739	22131.554
GA	1716.574	932.300	3453.796	6102.670
HI	162.168	113.750	457.114	733.032
ID	313.349	307.350	405.326	1026.024
IL	3031.360	1331.900	4615.512	8978.772
IN	1266.814	464.200	2327.965	4058.979
IA	1401.394	530.650	1151.128	3083.172
KS	600.490	178.250	1020.400	1799.140
KY	703.188	205.250	1238.760	2147.199
LA	1182.398	374.450	2863.070	4419.918
ME	748.729	179.500	683.879	1612.108
MD	1060.727	495.050	1481.634	3037.411
MA	2061.143	745.350	1195.212	4001.705
MI	4140.418	968.200	3807.828	8916.446
MN	2305.656	667.100	2743.673	5716.429
MS	1210.466	252.300	1751.906	3214.673
MO	909.666	393.450	1689.694	2992.810
MT	406.801	127.550	143.335	677.686
NE	300.800	120.650	563.904	985.355
NV	474.976	227.650	433.795	1136.421
NH	754.072	282.750	465.272	1502.094
NJ	2336.877	1107.950	1791.953	5236.780
NM	339.046	201.700	749.922	1290.668
NY	7133.262	1794.250	4096.228	13023.740
NC	2698.108	995.950	3442.960	7137.018
ND	194.349	47.550	309.824	551.723
OH	4143.991	1035.800	5535.261	10715.052
OK	744.766	179.000	1094.396	2018.162
OR	1652.031	319.950	241.597	2213.577
PA	5068.217	2391.050	3089.464	10548.731
RI	332.562	194.350	457.155	984.067
SC	1760.493	448.000	3080.153	5288.646
SD	234.186	67 400	319.176	620.762
TN	1686.764	580.900	1561.974	3829.638
TX	4020.128	1750.600	12099.080	17869.809
UT	737.501	314.350	649.436	1701.287
VT	348.832	80.550	233.480	662.863
VA	2753.915	1087.100	2468.416	6309.430
WA	4273.407	1466.700	1739.093	7479.200
WV	587.101	103.750	797.756	1488.607
WI	1612.254	390.600	2046.981	4049.835
WY	196.751	70.250	173.081	440.082
TOTAL:	87792.019	34525.350	105454.325	227771.694

*Assumes a $2.00 proof/gal FET increase on distilled spirits and "equalization" of FETs for wine and beer to that of distilled spirits.

STATEMENT OF CHRISTINE LUBINSKI, WASHINGTON REPRESENTATIVE, NATIONAL COUNCIL ON ALCOHOLISM, TESTIFYING ON BEHALF OF THE NATIONAL ALCOHOL TAX COALITION, WASHINGTON, DC

Ms. LUBINSKI. Thank you very much, Mr. Chairman. My name is Christine Lubinski. I am the Washington Representative for the National Council of Alcoholism and serve as an advocate for alcoholics and their family members—the sinners, as my colleague would have them.

Today I am representing the National Alcohol Tax Coalition which is supported by over 60 nonprofit organizations. We urge Congress to raise excise taxes on alcoholic beverages.

Specifically, the Coalition supports doubling the tax rate on distilled spirits and then raising beer and wine taxes to that liquor rate according to alcohol content.

These changes would generate an estimated $12 billion annually in new revenue. Equalizing tax rates across the beverage classes by raising beer and wine taxes to the distilled spirits rate alone would yield $4.7 billion.

Federal excise taxes on beer and table wine were last raised in 1951. Static taxes have allowed the real price of beer to fall 27 percent, of wine to fall 21 percent, and of distilled spirits to fall 48 percent between 1951 and 1983.

The erosion of the price of alcoholic beverages has been coupled with significant increases in alcohol consumption over the same period—alarmingly high consumption patterns, which have just begun to drop slightly over the last five years.

The failure of alcohol taxes to keep up with inflation has cost the U.S. Treasury upwards of $80 billion since 1951 and has made a significant contribution to the annual cost of alcohol problems to the nation, an awesome $20 billion a year; and I may add $25 billion to the Federal Treasury alone.

In addition to boosting the tax rates, Congress should index the rates to inflation to ensure that the price of alcoholic beverages keeps pace with other consumer goods.

Alcohol is alcohol is alcohol, yet current tax policy imposes substantially higher rates on distilled spirits than on beer and wine.

The alcohol in beer is taxed at about one-fourth the rate on liquor, and wine about one-seventeenth the rate. The Federal tax on a can of beer is only about 2.5 cents, and less than a penny on a glass of wine, while the tax on a shot of whiskey is about 10 cents.

Each of these drinks contains about the same amount of alcohol. Low taxes on beer and wine perpetuate the dangerous myth that beer and wine are somehow innocuous beverages of moderation.

Distilled spirits may be the most concentrated form of alcohol, but for teenagers beer is the overwhelming beverage of choice.

Beer is the beverage most frequently implicated in fatal auto accidents.

The CHAIRMAN. Now, Ms. Lubinski, let me interrupt because I did not hear your number. Did you say 2.5 cents is the tax on a can of beer?

Ms. LUBINSKI. That is correct, sir.

The CHAIRMAN. And what is it on a glass of wine?

Ms. **Lubinski**. A penny, and 10 cents for a shot of whiskey.

The **Chairman**. What about a bottle of wine? What would that be?

Ms. **Lubinski**. It is about three cents for a fifth of wine.

The **Chairman**. How much?

Ms. **Lubinski**. Three cents.

The **Chairman**. Three cents?

Ms. **Lubinski**. That is correct.

The **Chairman**. For a fifth?

Ms. **Lubinski**. Right.

Senator **Packwood**. I didn't know wine was sold in fifths.

The **Chairman**. I didn't either.

Ms. **Lubinski**. Well, I don't mean a fifth; I mean a regular 750 milliliter bottle.

The **Chairman**. I thought it was more than that. Well, all right. Go ahead.

Ms. **Lubinski**. Many health providers will tell you countless stories of pregnant women who think beer and wine are safe beverages during pregnancy or individuals who deny their alcoholism because they limit their heavy drinking to beer or wine.

Taxing alcohol at the same rate, regardless of beverage type, is an important step to reducing the tragic consequences associated with this myth.

Economists have developed impressive evidence that tax increases would be effective in reducing health and safety problems related to alcohol. Research suggests that raising the tax on beer would reduce highway fatalities among teenagers and young adults.

Studies at Duke University have correlated increased taxes at the State level with reduced levels of alcohol problems, including highway fatalities and cirrhosis of the liver.

Notably, the cirrhosis findings indicate that consumption by heavy drinkers is affected by tax-induced price increases. The tax increases that our coalition advocates would reduce costs of alcohol use by $16 billion annually.

Now, to address regressiveness. First, alcoholic beverages are obviously luxuries. It is the favorite mood changing drug of America and not essential, like telephone service or transportation.

Second, taxes on alcohol would hardly be felt by about two-thirds of the adult population. Forty percent of Americans abstain completely from alcohol, or drink less than one ounce a year. Another 29 percent drink less than three drinks a week.

Third, low-income households are much likelier than high-income households to abstain from alcohol, and among drinking households, upper income households spend over twice as much on alcohol as low income ones.

When the industry is not arguing regressiveness, they are arguing that consumers are already saddled with high taxes as a result of State initiatives.

Although many States have raised some alcohol taxes, on the average State taxes have fallen way behind inflation.

Between 1965 and 1984, State tax rates adjusted for inflation decreased 58 percent for beer and 53 percent for liquor.

Thank you. I ask that my full statement be included in the record.

The CHAIRMAN. That will be done. Thank you. Now, Mr. Martini, who is a member of the Wine Grape Growers of America. Mr. Martini, we are pleased to have you. Please proceed.

[The prepared statement of Ms. Lubinski follows:]

STATEMENT OF
THE NATIONAL ALCOHOL TAX COALITION
Presented by Christine Lubinski
National Council on Alcoholism

My name is Christine Lubinski. I am the Washington Representative for the National Council on Alcoholism. The National Council on Alcoholism, founded in 1944, is the nation's oldest and largest nonprofit health agency working nationwide to reduce alcoholism and other alcohol and drug related problems. NCA's programs provide leadership in the areas of prevention and education, public information, public policy advocacy, publications and affiliate services. NCA has 190 state and local affiliates which conduct similar activities in their areas and provide information and referral services to families and individuals seeking help with an alcohol or other drug problem.

I am here today on behalf of the National Alcohol Tax Coalition (NATC), a group of 30 national and dozens of state and local organizations. The Center for Science in the Public Interest coordinates the Coalition whose membership includes the American Association of Retired Persons, the Association of Junior Leagues, the Children's Defense Fund, and Remove Intoxicated Drivers.

We urge Congress to raise excise taxes on alcoholic beverages. The Coalition specifically supports the doubling of current excise tax rates on distilled spirits, and then equalizing beer and wine taxes at the liquor rate, according to alcohol content. These changes would provide an estimated $12 billion in new revenue. These proposed tax increases and equalization would result in a 13.7% decrease in consumption and a reduction of $16.4 billion annually in the economic cost of alcohol abuse and alcoholism now estimated at about $120 billion per year.

Our nation is faced with staggering budget deficits that threaten our economic vitality. Alcohol excise taxes offer this Committee and Congress as a whole an opportunity to significantly reduce the federal deficit while also contributing substantially to the public health.

Alcohol Tax Increases Are Long Overdue

Federal excise taxes on beer and table wine were last increased in 1951. The tax on distilled spirits rose 19 percent in October, 1985, but still lags well behind documented inflation since 1951. The Consumer Price Index rose 335 percent between 1951 and 1987. Adjusted for inflation, beer and wine taxes are lower than they have ever been since the end of Prohibition. Static taxes have allowed the real price of beer to fall 27 percent, of wine to fall 21 percent, and of distilled spirits to fall 48 percent between 1951 and 1983.(1)

The failure of alcohol excise taxes to keep up with inflation has been a windfall for the alcoholic beverage industry -- but a disaster for the public health and the Treasury. For the U.S. Treasury, it has meant the loss of about $80 to $100 billion in additional revenues between 1952 and the present. Now

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1. "Economic Report of the President," January, 1987, p. 187.

is the time for a major and long overdue overhaul of alcohol excise taxes.

The Public Supports Higher Alcohol Taxes

There is remarkably broad support for raising excise taxes on alcoholic beverages. Polls demonstrate that a large majority of the American public supports higher alcohol taxes.

- An August, 1984 Roper survey found that 77 percent of leadership persons surveyed (corporate executives, federal legislators, governors, religious leaders, educators, physicians, and the military command) approve of doubling the tax on alcoholic beverages to combat alcoholism. (2)
- A December, 1986 Gallup poll found that 66 percent of respondents supported doubling alcohol excise taxes to fight alcohol abuse. (3)
- A June 1987 Washington Post/ABC News poll found that 75 percent of respondents supported higher alcohol taxes. (4)

The New York Times, Los Angeles Times, and Washington Post have all editorialized in support of higher alcohol excise taxes.

Distinguished economists, including Martin Feldstein, Joseph A. Pechman, Henry J. Aaron, and Lester Thurow, have recognized the benefits attendant on an increase in alcohol excise taxes. In 1986, prominent economists, including three Nobel laureates, petitioned Congress to raise taxes on alcoholic beverages substantially, both to reduce budget deficits and improve the public health. These economists specifically called for equalizing the tax rates based on alcohol content.

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2. Roper Survey, August, 1984, sponsored by Christopher D. Smithers Foundation.
3. "Public Backs Strong Measure to Fight Alcohol, Drug Abuse," The Gallup Poll, December 18, 1986.
4. Washington Post/ABC News poll conducted 6/25/87 - 6/29/87 as reported in the Washington Post, July 2, 1987.

Last year at a Senate Finance Committee hearing, the Treasury Department supported excise tax increases on the grounds that "the consumption of alcoholic beverages produces social costs not reflected in their market price." (5) We estimate that direct and indirect costs to federal government plus tax expenditures related to alcohol problems amount to about $25 billion yearly.(6) Excise taxes on alcohol generated only $5.6 billion in fiscal year 1986.

Raising Excise Taxes Will Generate Up To $12 Billion

The National Alcohol Tax Coalition urges Congress to double the liquor tax rate and then equalize beer and wine at the liquor rate. Such action would yield about $12 billion annually in additional revenue and reduce the costs related to alcohol use by about $16 billion. If beer and wine taxes were simply raised to the current liquor rate, net revenues would increase by approximately $4.7 billion and the costs related to alcohol problems would be reduced by about $6 billion.

In addition to raising the tax rates, the rates should be indexed to inflation. Such a change would ensure that the relative price of alcoholic beverages in our economy remains stable, and would guarantee that the U.S. Treasury is never again robbed by inflation of billions of dollars in revenue. As the Treasury Department testified last year before the Senate Finance

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5. Statement of J. Roger Mentz, Department of the Treasury, before the Committee on Finance, U.S. Senate, April 21, 1986.
6. "Impact of Alcohol Excise Tax Increases on Federal Revenues, Alcohol Consumption, and Alcohol Problems," National Alcohol Tax Coalition, September 18, 1985, p.13, footnote 5.

Committee, "the alternative of having fixed rates slowly eroded by inflation is on balance undesirable. We thus support the Chairman's proposal [to adjust tax rates for inflation]."(7)

Tax Beverages Equally on Basis of Alcohol Content

We support equitable tax treatment for all types of alcoholic beverages. Currently, the alcohol in beer is taxed at about one-fourth the rate of liquor, and wine about one-seventeenth the rate. From both a public health and revenue perspective, these differentials make no sense.

Alcohol is alcohol is alcohol. In whatever form, alcohol can be addictive and its excessive use is dangerous and life threatening. Low taxes on beer and wine -- less than 3 cents on a 12-oz. can of beer, and less than 3 cents on a bottle of wine -- perpetuate the dangerous myth that beer and wine are somehow innocuous "beverages of moderation." Liquor may be the most concentrated form of alcohol, but for teenagers, who are at high risk of auto accidents and other violent events, beer is the favored beverage. Beer is the choice of most drivers who end up in fatal auto accidents. Alcohol, regardless of beverage type, should be taxed at the same rate.

Health and Social Benefits of Higher Alcohol Excise Taxes

While the alcoholic beverage industry fears that higher taxes would reduce sales and profits, it is worth emphasizing that alcohol, like cigarettes, is different from virtually all

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7. See note 5.

other products on the market. According to the National Institute on Alcohol Abuse and Alcoholism, the yearly toll of alcohol abuse and alcoholism is between 100,000 and 200,000 lives lost and about $120 billion in economic harm. Statistics, however, don't begin to describe the widespread suffering that results from excessive drinking.

While the tragedies of drinking and driving are well-known, alcohol is also related to half or more of all drownings, child abuse and other domestic violence, rapes and homicides. Alcohol affects practically every organ in the body and, in sufficient quantity, causes brain damage, liver cirrhosis, birth defects, heart disease, and cancers of the breast, liver, mouth, throat, esophagus, and larynx. The harm alcohol causes in the form of broken families, ruined careers, and school failure is incalculable. The dollar costs include health care costs, reduced productivity, and social welfare programs, among other factors. It is no wonder that alcohol is considered by many experts to be the number one drug problem in America.

In 1981, the National Research Council conducted a major examination of policies which would prevent alcohol abuse and alcoholism. The Council's report, "Alcohol and Public Policy," strongly linked the price of alcohol to alcohol problems. The Council concluded that "alcohol consumption and the problems caused by it respond to the price of alcoholic beverages, and we infer that the large reductions in the real cost of alcohol to consumers in recent years as likely to have exacerbated drinking problems."(8)

Economists at the National Bureau of Economic Research have presented impressive evidence that increases in beer taxes would be extremely effective in reducing highway fatalities among teenagers and young adults. They estimate that raising the tax on beer to equal the tax on distilled spirits would reduce accident deaths for 18 to 20 year-old males by 20 percent. Thousands of lives would be saved in the coming years. The 1987 Economic Report of the President to Congress said, "Higher alcohol taxes would also reduce fatalities. Studies of teen-age drunk driving indicate that if the real excise tax on beer were at its 1951 level, an estimated 1,000 fewer deaths per year would result, primarily of persons aged 18 to 21."(9)

Studies at Duke University have correlated increased taxes at the state level with reduced levels of alcohol-related problems. Economist Philip Cook examined the effects of 38 liquor tax increases in 30 states between 1961 and 1975. He found that increases correlated not only with decreased consumption, but also with decreases in cirrhosis of the liver and highway fatalities.(10) Notably, these findings indicate that alcohol consumption among heavy drinkers, those who suffer the most and cause the greatest harm related to alcohol, is affected by tax-induced price increases.

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8. Alcohol and Public Policy: Beyond the Shadow of Prohibition, National Research Council, 1981, p. 71.
9. "Economic Report of the President," January, 1987, p.188.
10. Cook, Phillip J., "Liquor Taxes and Drinking, Cirrhosis, and Auto Accidents in Alcohol and Public Policy: Beyond the Shadow of Prohibition, 1981.

Alcohol Excise Taxes Are Not Particularly Regressive

The alcoholic beverage industry has alleged that excise taxes are regressive -- that taxes on alcoholic beverages would hurt low-income consumers most. Although low-income consumers pay a higher proportion of their disposable income for a particular product than would high-income consumers, several factors distinguish taxes on alcoholic beverages from other excises, such as on gasoline or telephone service, and minimize discriminatory effects on the poor.

First, alcoholic beverages are relative luxuries -- discretionary items -- not essential items like telephone service and transportation. Second, as the Treasury Department advised the Senate Finance Committee last year, "a principal justification for imposing a Federal excise tax on ... alcoholic beverages is that the consumption of alcoholic beverages produces social costs not reflected in their market price."(11) Third, higher taxes on alcohol would hardly be felt by about two-thirds of the adult population. Forty percent of Americans abstain completely from alcoholic beverages or drink less than an ounce a year. Another 29 percent drink less than 3 drinks per week.(12)

Among drinkers, upper-income households spend over twice as much on alcoholic beverages as lower-income households. Lower-income persons, about 25 percent of whom are elderly persons who

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11. See note 5.
12. All figures in this section are from, "Alcohol Excise Tax Facts: Who Pays; and How Much?" National Alcohol Tax Coalition, May 1987.

consume the least alcohol of any adult cohort, spend only a small fraction -- around 3 percent -- of total expenditures on alcohol.

Industry marketing data on alcoholic beverages, compiled by the Simmons Market Research Bureau, and reported in Impact magazine (September 1, 1985), are instructive in determining the alleged regressive impact of increases in excise taxes on alcohol. For the highest category of household income ($50,000 and over), 49.4 percent report consumption of beer, 64.3 percent drink wine and 65.8 percent drink liquor. In contrast, only 30.2 percent of households with under $10,000 in income report drinking beer, 28.6 percent drink wine and 36.5 percent liquor. Even for households with income between $20,000 and $24,999, only 45.6 percent report drinking beer, 44.3 percent drink wine and 54.9 percent liquor. Therefore, increases in excise taxes on alcoholic beverages will be paid predominantly by those outside of the lowest income brackets.

Finally, according to the National Institute on Alcohol Abuse and Alcoholism, roughly 9.3 percent of drinkers consume 65 percent of all alcohol. Higher taxes -- and prices -- on alcoholic beverages would discourage excessive drinking among many in this relatively small fraction of all adults. Those who continued to drink heavily would be required to contribute more equitably to offset the costs of alcohol problems to society.

State Alcohol Taxes, Too, Have Increased Little

The alcoholic beverage industry sometimes argues that while federal excise taxes have not increased in 36 years (or in the case of distilled spirits, increased little) consumers are paying much higher taxes because states have raised their rates. Many states have indeed raised their tax rates, but on the average, state taxes on alcoholic beverages have fallen way behind inflation: between 1965 and 1984 state tax rates, adjusted for inflation, decreased 58 percent for beer and 53 percent for liquor.

Conclusion: Raise Taxes Now

On behalf of the National Alcohol Tax Coalition, I urge Members of this Committee to begin the long overdue process of responding to public sentiment and sound economic policy by raising alcohol excise taxes. Thirty-six years of inaction on alcohol excise taxes must be remedied. Congress should double the liquor tax, adjust beer and wine taxes to the liquor rate, and stabilize these rates by mandating annual adjustments for inflation. Such an action will infuse the painful process of raising revenues to reduce the federal budget deficit with a policy decision which serves the best interests of the public health.

STATEMENT OF JOHN MARTINI, MEMBER, WINE GRAPE GROWERS OF AMERICA, PENN YAN, NY

Mr. MARTINI. Good morning and thank you, sir. My name is John Martini, and thank you for the opportunity to allow the Wine Grape Growers to testify.

I would like to just summarize my written statement and have that submitted for the record.

The CHAIRMAN. Without objection, that will be done.

Mr. MARTINI. We feel that the pamphlet prepared by the Joint Taxation Committee failed to consider the agricultural implications any excise tax or increase in excise tax on wines might have. I presently serve as President of the New York State Wine Grape Growers, and I also represent the Wine Grape Growers of America.

Many members of this committee have wine industries in their States, but foremost, I am a wine grape grower myself. My wife and my children and I grow grapes in the Finger Lakes area of New York State.

The Wine Grape Growers believe that an increase in the excise tax will reduce the demand for wine, but probably not in the segment of society that might abuse it, and perhaps not in the premium end of the market; but rather in the popularly priced, nonvintage jug wines that are predominantly consumed by households and with meals.

This reduction will force lower prices for grapes for the farmer. Lower demand means lower prices. At this point in our existence, grape growers are not making enough money to meet the costs of production.

Let me briefly describe the grape industry.

Wine is grapes, and grapes are a labor and capital intensive product. It takes three years to produce a crop of grapes and six years before that vineyard comes into full production.

Roughly, it costs $6,000 an acre to grow an acre of grapes, or to start an acre of grapes.

In many cases, there are some varieties that find use as raisins or table grapes or in juice; but many grapes are wine grapes. They are seeded and not suitable for other areas of the grape industry; and those areas are already in a period of overproduction.

Wine grapes, unlike grain or rice, cannot be stored easily. It requires cold temperatures or addition of chemicals to keep them from fermenting.

Wine grape production exists in 38 States. Local governments make efforts to diversify growers or farmers away from traditional crops and encourage vineyard planting.

Wine grape growers at this time do not receive any of the current $2.6 billion farm program. And we are not asking for any of it; but we must compete for labor, supplies, and capital in a highly subsidized community.

The average New York vineyard—and this is true in other States—is not a large operation. It is 25 acres. Ninety percent of the vineyards in New York are under 100 acres; and between 1980 and 1985, we have lost 4,000 acres of grape production and over 400 growers.

There is a general perception, I think, on the part of the public that Falcon Crests exist in the grape industry. In fact, only three percent of the wines produced in this country are what we might call Appellation or premium wines. Napa and Sonoma Valley in California aside, the great bulk of the wines produced and consumed in this country are nonpremium and low priced wines.

Eighty percent are priced under $3.00 a 750 milliliter bottle. Seventy-four percent of that wine is consumed at home and 66 percent with meals.

The financial condition of wine grape growers at this time is stressed. Like all farmland, the debt is at record high levels, and prices are at eight-year lows.

One out of five short-term loans, or PCA loans in California, are considered serious problems by the Sacramento PCA.

The situation in New York is similar. And the long-term loan situation is even worse. In New York, we are losing between $300 and $500 an acre producing grapes that cost between $200 and $250 a ton to produce.

Recently, the largest winery in New York State reported a $2.7 million loss in the third quarter.

What about foreign wine production? Unfortunately, as grape growers, we are relatively expendable. There is a glut of wine worldwide.

In Europe, a distillation program provides a floor for their grape growers, as well as subsidies for transportation, concessionary credits, and special tax treatment.

The EEC also utilizes a reference price system for wines imported. In Canada, growers are guaranteed prices substantially above those paid for similar varieties in New York and Pennsylvania.

The recent USDA study, which I would also like to submit for the record, showed that there would be a $650 million loss due to an increase in excise taxes that might produce a $350 million income.

In conclusion, I would like to say that we are not looking at an industry in a period of strength. Grape prices in fact have gone down in the past five years.

Wine consumption is flat to down. We will see more foreclosures, more unemployment, and we don't believe that it is possible to raise the $350 million or the $12 billion, for that matter.

It seems that some people want to eat their cake and have it, too. You can't encourage reduction in consumption and expect to get an increase in income. Thank you, sir.

The CHAIRMAN. Thank you.

[The prepared written statement of Mr. Martini, the USDA study and supplemental information follows:]

Testimony by

John Martini
President, New York State Wine Grape Growers

on behalf of

WINEGRAPE GROWERS OF AMERICA, INC.

Mr. Chairman,

The Winegrape Growers of America, Inc., (WGA) is a federation of state winegrape grower associations. These states in turn represent a majority of the vineyard owners in the United States. Currently there are some thirty eight states involved in winegrape production. Our chairperson is from Texas, the vice chairperson is from California, the secretary is from Ohio, and the treasurer is from Virginia.

The purpose of WGA is to represent the state associations on federal issues and to provide a forum for an exchanges of information between the different state associations.

I am appearing today because the state associations are greatly concerned about proposals to increase the federal wine excise tax.

Let's briefly look at the vineyard industry. It requires three years of development before the first production of winegrapes begins and six years before full production. A vineyard is a permanent crop and unlike field or raw crops yearly rotation is not possible. Grapes are extremely perishable and unlike other commodities their uses are limited.

These family-run vineyard operations are like farmers everywhere -- they are already deeply in debt and one bad year could mean the difference between solvency and foreclosure. It costs about $6,000 an acre to establish a vineyard. Unlike an industrial operation, a vineyard cannot be put into storage, nor can the crop be simply plowed under like corn, wheat and other agricultural commodities. If the vineyards are abandoned or lost, they cannot be resurrected the next year without great financial inputs. Except for California, where some grapes can be used for raisins or table grape production (although this causes distortions in the raisin and table grape industries), winegrapes must be used for juice.

I remind this Committee that the winegrape industry does not have government subsidies or other Federal programs to fall back on. However, many vineyards are in areas where other crops are subsidized. Consequently, the winegrape growers must compete for labor, farm supplies, and land without the benefit of these subsidies.

In addition to the new problems this tax will cause for winegrape growers, this panel should consider several connected issues. For one thing, winegrape growers and small vintners have been responsible for the growth of a vibrant tourist trade in many rural areas, supporting bed and boards, hotels and restaurants. The death of these small vineyards, and the revenue they generate, would be catastrophic for many small businesses.

The source of the wine is the juice of an agricultural product -- the winegrape. Hence, farmers are major participants in the wine industry and in turn are extremely sensitive and dependent on the overall economic conditions of the wine industry.

The wine industry since the end of 1981 has been suffering from heavy planting in the 1978-1981 period, oversupply related to bumper crops, and foreign competition. The industry at a consumer level has been plagued with stagnation in volume and weakness in prices, particularly for traditional generic wines made from grapes. Wine coolers, which generally contain less than 50% grape content, and the very small premium wine markets have shown some strong growth, but the high volume generic wine business has been declining in volume. The white generic table wine segment of the industry, which accounts for about 50% of all wine sold, has been unable to increase prices sufficiently to offset inflation.

The total of all wine excise taxes including imports produced an estimated total of $270 million in federal tax revenue in 1986. Over $150 million of the revenue (55%) was generated by the relatively high tax on the low volume sparking wine category. In 1986, the domestically produced table wine category generated an estimated $68 million in tax revenue. Because of this low base and because of the current dire economic conditions in the table wine and grape industries, the table wine excise tax is a poor revenue option at this time.

State wine excise taxes are higher than other alcoholic beverages in all the states except for three.

According to the Bureau of Labor Statistics, the Producer Price Index for white generic table wine prices in April 1987 was 7.4% lower than December 1983, the starting point for the series. Any increase in tax will have a further negative effect on the market and income. Rather than increase operating losses, it should be expected that some wineries, like any other businesses, would attempt to offset higher taxes by lowering raw material costs simply because they are competing against imported wines which receive government assistance and the resulting surplus of grape juice in the domestic market.

The U.S. International Trade Commission Report (Publication #1771, October 1985) on countervailing duties relative to imported wines indicated that eight of the ten largest producers of non-premium table wines experienced operating losses in 1984. With no significant improvement occurring since then, with the exception of the separate wine cooler category, grape growers would undoubtedly be forced to absorb much of the impact of any excise tax increase in the form of lower grape prices. Accordingly, rather than a "wine excise tax" the increase would become a "farmer's tax", caused by the resulting wine surplus and the increased excise tax.

Equally alarming is the economic condition of the New York state winegrape vineyard owners. In a 1984 study the growers learned that they suffered a loss on all varieties of winegrapes harvested. On concord grapes they lost an average of $568 per acre and lost $365 on the Delaware variety of grapes. Please note this does not include mortgage interest, but only production costs. I estimate another $180 per acre cost can be added to the above losses per acre. Similar results were experienced by growers in Pennsylvania.

Growers of Thompson Seedless, French Colombard, Chenin Blanc, and other generic grapes are the backbone of the U.S. table wine business. Unlike grape growers in France and Italy, U.S. grape growers receive no government subsidies, nor have they received any significant protection in the form of tariffs or trade barriers. In the absence of such support, the level of wine excise tax becomes a critical economic factor to the grape grower. With today's financial crisis on most farms, the grower can ill afford to absorb any additional costs.

Prices for generic table wine grapes in California can be characterized as severely depressed. Average prices for Thompson Seedless grapes in 1984 and 1985 were 60% below the 1981 peak levels and 50% below the levels of 1978 to 1980. Although recovering somewhat, the 1986 average price of $105 per ton paid by wineries was hardly above the 1977 price level and was below the current break-even point for most growers.

The current table wine excise tax of 17 cents per gallon converts to close to $30 per ton. The average 1986 price of Thompson Seedless, Chenin Blanc and French Colombard grapes in California was $131 per ton. With ten tons per acre yields, most growers of such grapes cannot cover their out-of-pocket farming costs, and growers with any significant debt are unable to service interest charges. Any significant increase in the wine excise tax, therefore, will aggravate a serious agricultural financial problem and increase farm foreclosures.

In reviewing the Joint Tax Committee staff revenue options pamphlet we noticed the absence of the U.S. Department of Agriculture's April 1986 analysis of an increase in the federal wine excise tax on the grape and wine industry (attached). Some of the federal government findings were:

- a scale back by the industry caused by the increased wine excise tax would cost the economy as a whole more than the likely increase in revenue.

- if an added excise tax increase of \$.17 to \$.87 were passed back to the producer, it would be the equivalent of \$115 per ton of grapes on two thirds of the price received by growers over the last several years, and

- the likely \$650 million loss if the wine excise tax is increased to the above amount was enacted compares with added excise tax revenues of possibly \$350 million.

Unfortunately winegrapes do not have to be grown in the United States. The world surplus of wine is monumental and since the U.S. has no quotas and relatively low tariffs compared to other non-EEC nations, the U.S. is an excellent market for foreign wines.

We have all heard of or watched the program Falcon Crest. This program portrays a region of California that has been just as successful as the appellations in France known as Bordeaux and Burgundy. Unfortunately for the winegrape growers these appellations are unique. This probably represents less than three percent of the nation's production. Almost all of our wine is known as bulk or ordinary table wine. Any increase in wine excise tax will fall the heaviest on the low and middle income families because the excise tax does not discriminate between the wines.

In summary, a large scale sudden increase in wine excise tax would not generate a meaningful enhancement of total tax revenue. If enacted, any increase is likely to be passed to the consumer in higher prices and would result in lower grape prices to the farmers. The result is likely to be a further deterioration in the financial plight of grape growers and increased farm foreclosures.

New York State Winegrape Study
1984

Income

Concord Grape

Yield: 4.64 tons per acre
Price: $177 per ton = $821 per acre

Delaware grape

Yield: 3.24 tons per acre
Price: $316 per ton = $1,024 per acre

Expenses
Production costs per acre $1,389
(mortgage interest not included)

Profit or (loss)

Concord	($568)
Delaware	($365)

CHANGE IN TABLE WINE PRICE INDICES

	Dec. 1983	Dec. 1986	Average 3 Year Change	April 1987
White Table Wines - Generic (1)	100.0	90.8	(3.1)%	92.6
Grape Table Wine (1)	100.0	99.6	(0.1)%	103.3
Alcoholic Beverages (1)	100.0	105.9	+2.0%	107.0
Consumer Price Index	100.0	109.1	+3.0%	111.3

(1) Producer Price Index, U. S. Bureau of Labor Statistics

ESTIMATED WINE EXCISE TAX

	Wine (gals in millions) Entering Distribution Channel in US				$ Million Estimated Tax Revenue		
	U.S. Produced	Imports	Total	Current Tax Rate $/Gal	U.S. Produced Wine	Imported Wine	Total
Table Wines	399	89	488	$ .17	$ 68	$ 15	$ 83
Dessert & Vermouth	49	6	55	.67	33	4	37
Sparkling Wines	30	14	44	3.40	102	48	150
Total	478	109	587		$203	$ 67	$270

1986 California Grape Crush

	Tons (000)	$/TON	$Millions
Thompson Seedless	445	$104	$ 46
Chenin Blanc	301	159	48
French Colombard	677	136	92
Subtotal	1,423	$131	$186
All Others	1,370		334
Total Crushed	2,793	$186	$520

PRICES BY MASSACHUSETTS WHOLESALERS
GENERIC - 3.0 LITER SIZE

$/CASE
AFTER REVENUE

($/CASE)	SEPT/OCT 1986	SEPT 1982	% CHANGE
CRIBARI	$18.20	$19.10	-5%
COLONY	18.36	20.80	-12%
CARLO ROSSI	15.45	19.20*	-20%
GALLO	17.90	20.05	-11%
ALMADEN	21.85	27.20	-20%

*NO REVENUE

TOTAL SHIPMENTS OF ALL CALIFORNIA WINES TO ALL MARKETS

GROWTH %

	TOTAL AS PUBLISHED	EX COOLER	WITH WINE CONTENT OF COOLER
1981	+5.8%	+5.8%	+5.8%
1982	+0.1%	+0.1%	+0.1%
1983	+1.4%	(0.3%)	+0.6%
1984	+2.6%	(3.3%)	(0.3%)
1985	+5.0%	(3.2%)	+1.1%
1986 PROJ.	+8.0%	+2.8%	+5.6%

CENTRAL VALLEY VINEYARD

CHENIN BLANC

$/ACRE	
REVENUE (10 TONS @ $125)	$1,250.
OUT OF POCKET FARMING COSTS	800.
ADMINISTRATION EXPENSES	200.
VINE REPLACEMENT	
TOTAL COSTS	$1,000.
OPERATING PROFIT BEFORE INTEREST	$ 250.
VINEYARD VALUE PER ACRE	?.

RAISIN GRAPES - 1987

	BEARING ACRES	NORMAL CROP (TONS)
TOTAL SUPPLY	276,540	2,410,000
UTILIZATION		
Dried Raisin Market		1,440,000 tons
Canned and Table Markets		390,000
Balance		580,000 tons
Wineries		500,000
Surplus		80,000
		3%
Diversion Program		135,000

RAISIN GRAPE ANALYSIS

	Price ($/ton)	Yield Tons/Acre	Per Acre	Planted
1976	$ 85	8.2	$ 697	2,301
1977	100	8.0	800	3,845
1978	153	7.0	1,065	7,494
1979	150	9.7	1,449	12,193
1980	144	11.0	1,585	15,396
1981	200	7.1	1,416	10,742
1982	127	10.1	1,281	8,281
1983	104	8.9	920	4,519
1984	78	8.0	626	2,569
1985	75	9.2	683	803
1986	105	8.8	924	613
1987	120	8.8	1,056	1,000

WINEGRAPE GROWERS OF AMERICA
517 C STREET, N.E. • WASHINGTON, D.C. 20002-5809 • 202-543-4455

July 16, 1987

The Honorable Lloyd Bentsen
Chairman
Senate Committee on Finance
205 SDOB
Washington, D.C. 20510-6200

Re: July 16th Hearing on Revenue Options

Dear Senator Bentsen:

This letter is to supplement the information given by me as the witness for Winegrape Growers of America during your Thursday, July 16 hearing on revenue options and to revisit the Chairman's question if the winegrape growers could accept the doubling of the current wine excise tax. I have reconsidered the question I would like the record to show that I would oppose any wine excise tax increase.

Our winegrape grower industry is currently operating at a loss and any increase will aggravate the economic condition. In the United States there is a serious excess capacity and together with the world surplus of wine, an excise tax increase at this time would be counterproductive.

Last year, the U.S. Department of Agriculture studied your committee's proposed excise tax increase and determined the tax would "place a special burden on the grape and wine industry." Attached is copy of the Department's letter and our association urges your committee to invite the Department to discuss their findings with you.

In reference to the committee's responsibility to raise revenue, the study determined that in return for excise tax revenues of $350 million, the economy would lose $650 million. On the micro level, considering the current loss of approximately $400 per acre, excluding mortgage interest, some vineyard owners will definitely be forced out of the industry. Unlike other agricultural commodities, we do not benefit from U.S. government support funds.

This nation does not need vineyards to support a wine industry. Like other nation's practices (Canada's, Japan's and South Korea's), wine can be produced in Europe and brought into the United States to be bottled. While we do not foresee our entire vineyard industry being destroyed by the tax increase, there will definitely be a decrease in acreage.

The European winegrape growers have a distinct interest in seeing the excise tax increase. The EEC wine surplus is a financial problem for the Community because of the costly support programs for their growers (U.S. growers receive no federal farm assistance). These programs include:

vineyard removal incentive program,

storage and distillation program, and

modernization program.

Approximately one half of the EEC wine production enters the distillation program and as our vineyards are removed, the EEC wine will be imported, replacing our production. In one decade, U.S. wine imports increased from approximately 15 percent to 25 percent for several reasons, including the EEC glut of bulk table wine.

Probably the most important factor for your consideration is the illusory or false premonition that the U.S. Treasury will receive increased revenues. In 1986, $270 million in wine excise taxes was received by the Treasury, $150 million of which came from the low volume, highly taxed sparkling wine/champagne wine category. Only $68 million came from the U.S. domestic table wine market.

Another fact not discussed at the hearing is state excise taxes. Wine is taxed higher than other alcoholic beverages in forty seven states.

In the hearing, Senator Riegle referred to the possibility that some of the excise taxes may be at a level which discourages consumption. The wine industry is experiencing a reduction in consumption and white generic table wine prices are down 7 percent compared to 1983. This decrease is reflected in prices paid to the growers. Clearly the regressive nature of the wine excise tax will unfairly impact the consumer and grower.

I request that my letter be inserted in the record immediately after my testimony.

Sincerely yours,

John Martini

cc: Committee members in attendance

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

April 29, 1986

Honorable Pete Wilson
United States Senate
Washington, D.C. 20510

Dear Senator Wilson:

Thank you for your recent letter requesting Department analysis of the impact of the Senate Finance Committee's Tax Reform Bill on the grape and wine industry.

The bill contains three provisions that would affect the industry. It calls for:

- Elimination of excise tax deductibility for Federal income tax purposes;
- Indexing of excise taxes on alcohol, tobacco, and fuel; and
- An increase in the excise tax on wine to make it equivalent to the excise tax on beer on a per unit of alcohol basis.

The first two provisions would affect the grape and wine industries along with all other industries subject to Federal excise taxes. Their impact would be possibly more significant than the impact of excise tax equalization, but neither provision would impose any unique burden on the industry.

The third provision, however, would put a special burden on the grape and wine industry. Under current law, wine containing less than 21 percent alcohol is subject to a tax of approximately $5.50 per barrel. This rate is substantially lower than the rate for beer, particularly if the two are compared on an alcohol content basis. The differences in rates has traditionally been justified in part on the basis of industry claims that wine is used as more than an alcoholic beverage. Assuming beer is 4 percent alcohol, the typical beer tax of $31 per barrel is the equivalent of a tax of 7.25 percent per 1 percent of alcohol per gallon. The typical table wine with a 12 percent alcohol content is taxed at less than 1.5 percent per 1 percent of alcohol per gallon. The Senate Finance Committee's proposal raises the tax rate on wine to equal the rate on beer. This would increase the tax on table wine, the category most seriously affected, from 15-20 cents to 85-90 cents a bottle. This is the equivalent of a 10 percent increase in retail prices.

While it is difficult to forecast how much of the added tax would be passed backward to producers or forward to consumers, the adjustments involved in either case are significant enough to raise serious questions. If the tax increase were passed back to winery and vineyard operators, it would add to pressure on an industry faced with serious excess capacity problems. If passed forward to consumers, the tax would reduce demand for wine enough to force the industry to scale back. Given the industry's links to other sectors of the economy, a scale-back could cost the economy as a whole more than the likely increase in revenue.

If all of the added tax in question was passed back to producers, it would be the equivalent of $115 per ton of grapes or two-thirds of the price received by growers over the last several years. Clearly, all of the tax could not be passed back to producers despite supply and demand elasticities that suggest growers would normally absorb all or most of the adjustment.

If part or all of the added excise tax were passed on to consumers, the impact on the industry would be somewhat less, but the tax would reduce economic activity outside the sector more than enough to offset any lessening of pressure on the grape and wine industry. A 10 percent increase in the retail price of wine would reduce wine demand 5-6 percent. Assuming such a reduction was spread evenly between domestic and imported wines, U.S. wineries would loose up to 24 million gallons of demand and vineyards would loose a market for 150,000 tons of grapes. This industry loss would affect activity well beyond the sector. Industry economists estimate employment in grape and winery operations at more than 200,000 and suggest that every dollar in activity at the vineyard level ultimately generates another $1.86 in activity while $1 at the winery level ultimately generates another $2.20 in activity.

Given these linkages, the loss of 150,000 tons in grape sales would translate into a $90-million decline in grape sales and related activity up to the vineyard level. The tax would also reduce sales at the winery level $175 million; a loss in winery activity of this magnitude would reduce overall activity in the economy $560 million. Hence, losses at the vineyard and winery levels combined with associated losses elsewhere in the economy could total $650 million.

While the industry data used to generate these impact estimates may overstate vineyard and winery linkages to the rest of the economy, their estimates are comparable to estimates made in university and government circles. The $650 million loss likely if the equalization provision were passed compares with added excise tax revenues of possibly $350 million. The industry's total tax burden with the new provision in place would increase to more than $650 million.

I hope this information is helpful.

Sincerely,

Robert L. Thompson

ROBERT L. THOMPSON
Assistant Secretary
for Economics

The **Chairman**. Mr. Martini, would you comment on what the amount of excise tax is on a bottle of wine?

Mr. **Martini**. The excise tax presently?

The **Chairman**. Yes.

Mr. **Martini**. It is 17 cents a gallon on distilled wine.

The **Chairman**. What is it on a regular bottle?

Mr. **Martini**. All right. A regular bottle is 750 milliliters. It used to be sold in fifths—a fifth of a gallon; 750 milliliters is now the size of choice, which is close to a fifth of a gallon; and the tax on that would be five into 17, or about 3.5 cents a bottle.

The **Chairman**. 3.5 cents?

Mr. **Martini**. 3.5 cents a bottle. Right.

The **Chairman**. For a bottle?

Mr. **Martini**. Right.

The **Chairman**. Do you think if that was seven cents, it would materially reduce the consumption of wine?

Mr. **Martini**. In a $10.00 bottle of wine, no, sir; but most wines are not $10.00 a bottle.

The **Chairman**. If it is a $5.00 bottle, and you go from 3.5 cents for a bottle of wine to 7 cents, do you think that is going to have a material effect on consumption?

Mr. **Martini**. I think that in the end—Let's say it was $2.00 a bottle; it wouldn't be $2.07. Those increases will be passed along.

The **Chairman**. When was the excise tax—pardon me, I used to smoke too much. [Laughter.]

Pardon me, Mr. Whitley.

Mr. **Whitley**. Yes, sir.

The **Chairman**. When was it last raised, Mr. Martini?

Mr. **Martini**. I believe in 1955.

The **Chairman**. So, in effect, the tax on wine has been reduced as related to inflation and costs?

Mr. **Martini**. If you relate it to inflation, that is correct.

The **Chairman**. Yes.

Mr. **Martini**. But States have raised excise taxes.

The **Chairman**. All right. Now, Mr. Whitley, are you aware that the Office of Technology Assessment estimates that cigarette smoking costs the economy $65 billion annually in health care—in health care costs—and lost productivity?

Did you know that a Harvard University study shows that doubling the tobacco excise tax will discourage nearly one million teenagers from smoking?

Are you aware that we are told that doubling the current excise tax on tobacco would save over 800,000 premature deaths over the next 30 to 50 years?

Now, those statistics to me are staggering. Do you challenge them?

Mr. **Whitley**. Yes, sir. We do. You can prove, as the Senator well knows, anything you want to by statistics. There are various sets of statistics that are normally based on hypotheses that you have to examine very carefully in order to assess their validity.

And certainly, we will concede that if you increase the excise tax on cigarettes, it will generally reduce consumption. That happened. The excise tax was doubled from eight cents to 16 cents. We lost 14,000 direct jobs in the industry.

If it should be doubled again, we would lose at least 35,000 more.

But again, to hypothesize that it would reduce teenage smoking, we think—as I said previously—it just totally defies logic as well as flying in the face of a large body of empirical evidence put together by survey research that has determined that the significant factors in teenagers deciding to smoke or not to smoke is not whether the pack of cigarettes might cost 10 cents more or 8 cents more or 16 cents more—as I said $1.25 as opposed to $1.10.

It is peer influence; it is the habits of parents, siblings, others in the homes, and a number of other cultural factors.

Insofar as these numbers like $60 billion and all that sort of thing, we just don't believe they can justify that at all. And as I said, even if you wanted to accept that these are "costs," whatever costs there are associated with smoking we think is borne by the smoker and not by some nebulous concept of society.

The direct medical costs, that Mr. Myers says, is paid by the Federal Government for smoking-related diseases, illnesses, and so forth. He says that it is $4.8 billion; if you accept that number, smokers pay $4.7 billion——

The CHAIRMAN. My time is about to run out, and I would like to make another point to Mr. Metz' testimony. You referred to Alexander Hamilton and his opposition to the excise tax.

I think of this trip that is being made to Philadelphia today, and I can't help but recall the story of Mr. Hamilton back in 1791 as he was trying to take care of some budget problems and they put the first excise tax on distilled spirits at that time.

Now, Mr. Myers, do you represent any economic interest group, other than those that are concerned in health? Would you comment on that?

Mr. MYERS. I am not sure what you mean by "any economic interest group." I am here representing——

The CHAIRMAN. I mean a for-profit interest group.

Mr. MYERS. No, I do not, Mr. Chairman.

The CHAIRMAN. Thank you. Ms. Lubinski, as you look at the question of excise taxes on alcohol, and you spoke to the question of regressive taxes, are you more concerned with that point? Or are you concerned with trying to see that we put an inflation factor in there for the future?

Ms. LUBINSKI. I think I tried to argue that regressiveness is not a strong issue with alcohol excise taxes because drinking in our society is so concentrated and there are so many Americans who don't drink at all which really changes the picture.

I think that we are really concerned about generally the low levels of excise taxes, the differential levels on taxes that send inappropriate messages about the three beverages, and also that alcohol gets cheaper and cheaper as other commodities get more expensive with the inflation factor.

So, certainly, putting an inflation factor in excise taxes, particularly if they were raised at the same time, would protect the price. It would keep the price of alcohol over the next 10 to 20 years in keeping with other consumer goods and probably would have the most long-term impact.

The CHAIRMAN. Thank you very much. I see my time has expired. The sequence of arrival this morning of Senators is Packwood, Chafee, Rockefeller, and Daschle. Senator Packwood?

Senator PACKWOOD. Congressman Whitley, on the cigarette tax, one of two things—it seems to me—has to be a conclusion.

Either a higher price does deter people from smoking—especially young people—or it does not. If it does not deter them, then the cigarette tax—absent the argument of fairness, which is one we will have to decide—is an absolute horn-of-plenty in terms of revenue that simply can be expanded forever.

Or indeed, it does have a deterring effect as the price goes up. Which is it?

Mr. WHITLEY. Senator, I think our response to that would be that, among certain smokers, it has been demonstrated that increasing the excise tax will reduce smoking.

My testimony earlier was—and we stand by that—that teenagers don't exactly have the same attitude about the spending of money and the use of money that older persons do who are earning their own.

Senator PACKWOOD. So, you think there is no price that would deter teenagers from smoking?

Mr. WHITLEY. No, sir. I wouldn't say that, but the highest that we have heard anyone suggest on cigarettes is doubling the present, which would be 16 cents a pack.

We contend that would not be any deterrent to teenagers.

Senator PACKWOOD. Mr. Metz, let me ask you this. The last sentence in your statement is that not only do you not want excise taxes increased, but you say we should eliminate excise taxes "in favor of broader-based and less discriminating forms of business taxation." What form?

Mr. METZ. Senator, it is not the purpose of our association to mention any specific form of alternative revenue source. That is not our competence.

We want to work along with this committee in light of the principles and criteria that we commend to it. As you may know, we were very active as part of the steering committee of the Tax Reform Action Coalition; therefore, we approach our responsibilities very seriously.

And we are also a vice president of the Coalition Against Regressive Taxation. So, we have set forth our criteria for alternatives to excise taxes, and we will be willing to work with this committee.

Senator PACKWOOD. It is not exactly what form. I want to know what a broad-based, less discriminatory form of business taxation is. Is it an increase in corporate rates? What direction, roughly, are you talking about?

Mr. METZ. We would feel that any leveling of the playing field would be appropriate as far as excise taxes. They are anachronisms. Virtually, there is no rationale for the industries that have been selected historically.

Senator PACKWOOD. I understand that. I want to know the answer to one question: what is a broad-based, less discriminatory business tax? Give me an example of one.

Mr. METZ. There are several that have been mentioned in the Joint Committee's proposal, and we neither endorse any particular one. There are value added types of taxes of all types and varities that have been suggested.

There are several proposals in the Joint Committee—

Senator PACKWOOD. You would count a value-added tax as a broadly-based, nonregressive tax?

Mr. METZ. Not necessarily per se, not regressive. No. there are regressive aspects to any type of consumption tax.

Senator PACKWOOD. All right. Let me ask a question of a couple of the other witnesses. I will preface it with this.

When we were doing the Tax Reform bill, we had testimony on the alternative minimum tax. One of our witnesses was a managing partner of a large Big Eight accounting firm. He was vehemently in opposition to the alternative minimum tax, and somewhat sarcastic about it.

Several of the committee members asked this man for help. What should we do? And his answer was not unlike yours: "Nothing. We don't want the alternative minimum tax; it is terrible."

He gave us no help or advice, and we passed an alternative minimum tax. And this man has been going about the country bleating and complaining ever since, but he gave us no direction at all.

Now, assuming we have to raise $19 to $21 billion in taxes next year, and $60 to $70 billion over three years, in what direction should we be heading? I would like to put that question to the three trade association representatives.

Let me start with Mr. Martini.

Mr. MARTINI. Yes, sir. What do I think?

Senator PACKWOOD. Yes.

Mr. MARTINI. Personally, I would keep the tax rates high on the income tax.

Senator PACKWOOD. I am not sure that is an answer. Individual or corporate, or both?

Mr. MARTINI. I guess I look at it as we have to pay the bills. The country is all the people in it.

Senator PACKWOOD. But your basic answer would be higher rates?

Mr. MARTINI. Higher rates, or don't lower them.

Senator PACKWOOD. All right. Congressman Whitley?

Mr. WHITLEY. Senator, our member companies haven't taken a position on specific taxes, but I would remind the Senator that all of the major cigarette manufacturers strongly supported the Tax Reform Act that was approved by this committee and the last Congress; and they did this because they felt that the rate changes in the other divisions were broadly based and were uniformly fair.

An approach that takes a broadly based tax and is uniformly fair certainly would be far more likely to be supported by our industry than one that is narrowly based and regressive.

Senator PACKWOOD. What does that mean?

Mr. WHITLEY. That means that they would be far more likely, as I said, to support a broadly based tax that does things at all income levels.

Senator PACKWOOD. Give me an example.

Mr. WHITLEY. Obviously, that kind of tax would be the income tax.

Senator PACKWOOD. All right. And if necessary, you would support raising the rates?

Mr. WHITLEY. I cannot speak for our member companies in saying that, but certainly, their past attitude toward taxation and endorsing reform in the last Congress indicates their support of a fair and broadly based tax.

Senator PACKWOOD. All right. Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Ms. Lubinski, I was interested in your comment on page 9 where you say, "40 percent of Americans abstain completely from alcoholic beverages or drink less than an ounce a year." If they drink less than an ounce a year, I would say that is total abstention.

Ms. LUBINSKI. It is close to it, Senator. [Laughter.]

Senator CHAFEE. I am amazed at that statistic—40 percent?

Ms. LUBINSKI. Yes. That is actually from the latest report from the Federal agency, the National Institute on Alcohol Abuse and Alcoholism.

Senator CHAFEE. Is that working on some basis that if there is X amount of alcohol consumed then there is one group that consumes seven drinks a week; therefore, there must be some people left who don't drink anything?

Ms. LUBINSKI. That is from a number of sources, including household surveys, where people identify themselves very specifically as abstainers from alcoholic beverages.

And I stress that in my testimony because there really are many people who think that 90 percent of folks drink moderately or socially, and then there is this small group that drinks very heavily. And in fact, I think it is important for people to know that the United States is unusual in that respect, in having such a large cohort of abstainers.

Senator CHAFEE. Does that include the population as a total—every man, woman, and child? In other words, I presume the statistics would be substantially built up by children under 10.

Ms. LUBINSKI. That does not include children under 10. It does, however, include Americans 14 and over because 12 seems to be the average age of onset of drinking. So, it does include 14 and over, I believe, in measuring that statistic.

Senator CHAFEE. Now, Mr. Metz, I notice that you are representing the Wine and Spirits Wholesalers, namely the distilled spirits.

In this committee, as you know, over the past six years, we have very substantially increased the taxes on distilled spirits. And so, it seems to me that I would put that in a different category than wine and indeed beer. You don't represent beer.

The statistics, as I have seen them, on the distilled spirits is that the tax increases we have imposed on them—on that industry—have resulted—or the statistics of the industry as a whole, and whether it is due to taxes or not, I don't know—is at best level and I believe declining sales. Is that true?

Mr. METZ. That is true, Senator.

Senator CHAFEE. And so, therefore, it is an industry that, due to changing lifestyles or a variety of factors—wine coolers and so forth—is just taking a decreasing share of the market.

Mr. METZ. We are concerned also about wine, when we see figures and experience declines in sales of approximately three percent in the last two years in table wine—the type that Mr. Martini was talking about.

Senator CHAFEE. What is your definition of wine? What alcoholic content do you start with? In other words, I assume the wine coolers are not part of your group, or are they?

Mr. METZ. Our members also distribute wine coolers. Members of the beer industry do also.

Senator CHAFEE. Is that included in your statistics?

Mr. METZ. In terms of table wine, no, which is really the primary wine product that we inventory and distribute to the retail trade.

We are concerned, Senator, that any increase in the wine tax, by any level of Government—State, local or Federal—will result in the same problems and exacerbate them, which are now being experienced in the——

Senator CHAFEE. I appreciate that you are riding two horses here today, but I see a difference between the distilled spirits and the wine.

As Ms. Lubinski has pointed out, the taxation based on alcoholic content is way different. I don't know what the statistics are, but I would suspect that it is as great as a tenfold difference. Is that correct, Ms. Lubinski?

Ms. LUBINSKI. Distilled spirits are taxed at 17 times the rate of wine.

Senator CHAFEE. So, I think that in distilled spirits we indeed do have a situation where the tax—certainly when combined with the State tax—is a substantial cost of the product and has contributed to the decline in sales.

Wine, I see differently. As the chairman pointed out in his discussion with you and Ms. Lubinski's figures about three cents a bottle—of 750 milliliters—and going to six cents is really very marginal.

In most States, the sales tax is not included. The sales tax, at least in my State, applies to alcoholic beverages, including wine. So, you see the price, and then you go to the counter; and then six percent is added to it.

I presume that hasn't affected the sales, and I can hardly believe that in wine, doubling the tax is going to make any difference.

Mr. METZ. Senator——

Senator CHAFEE. May he just respond to this?

The CHAIRMAN. Yes, of course.

Mr. METZ. Senator, our position is consistent and clear.

Number one, we think that——

Senator CHAFEE. It has been consistent; I am not sure it is clear.

Mr. METZ. I will try to make it clear. First, we oppose increases of any type in Federal excise taxes on alcoholic beverages, as a matter of tax policy in relation to what is happening in terms of taxation of our industry and the share of revenue dependency by the State governments.

Number two, any increased tax burden will have an adverse effect on our industry—and we believe on consumers as well—in the form of regressive taxes.

Senator CHAFEE. I am addressing the wine; I am not addressing the distilled spirits.

Mr. METZ. We just cannot support increased tax burdens in the face of declining sales.

Senator CHAFEE. I didn't expect you to support it. I expected you to be less aggressive and resistant. [Laughter.]

Mr. METZ. We are not. When we look at the State level, the State tax burden averages over 50 cents a gallon, or three or four times that of the Federal tax rate.

So, there is a tax burden that is not recognized when one considers solely the burden of the Federal tax rate on either wine or distilled spirits.

Senator CHAFEE. Fine. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Rockefeller?

Senator ROCKEFELLER. I have no questions, Mr. Chairman.

The CHAIRMAN. Senator Daschle?

Senator DASCHLE. Thank you, Mr. Chairman. I would like to pick up where Senator Chafee left off with regard to, first, spirits and wine.

I think we are talking about two issues here, and I would like to clarify them if I could. The first is taxing alcohol on the basis of alcohol content.

Now, there is a disparity, I think, of some 17 times in the difference between wine and distilled spirits. The wine industry has long opposed the calculation of tax based upon some recalculation of the formula by which that alcohol tax is determined.

But if I understand you, Mr. Martini, you are not necessarily appearing before the committee this morning to indicate that you oppose the consideration of some alteration of the tax as long as it doesn't change the formula. Is that a correct assessment of your statement?

Mr. MARTINI. No, I am afraid it probably isn't. As we understand it, the proposed increase—it is not a doubling, but it is 17 times to make it equal to distilled spirits—and that results in a 50 to 60 cent increase in a bottle of wine, rather than a 7 cent increase.

Senator DASCHLE. So, in other words, to bring wine up with distilled spirits, you are talking about a 60 cent——

Mr. MARTINI. On a bottle of wine.

Senator DASCHLE. On a bottle?

Mr. MARTINI. Right. On a 750 ml bottle. That is right. And as I said, most of the wines consumed in this country are $2.00 a bottle or $1.50 a bottle and so on.

Senator DASCHLE. The sense I had in your responses to Senator Bentsen's questions is that you would see an increase of 7 to 8 cents; and you didn't appear to believe that that would be a detrimental factor in the sale of wine in the future. Is that not a correct assessment of your responses?

Mr. MARTINI. At 7 cents? It probably wouldn't have an effect, but I don't believe that is the proposal.

Senator DASCHLE. In 1985, when the distilled spirits took a new tax on their product, wine was exempt. If you were to see a similar increase in the tax on wine that they took in 1985, what would that be on a 750 ml bottle?

Mr. MARTINI. They doubled it, right?

Senator Daschle. Yes.

Mr. Martini. I am not sure how much theirs went up.

Ms. Lubinski. It was 19 percent.

Mr. Martini. 19 percent.

Senator Daschle. So, if you saw a 19 percent increase over what you are paying right now—we are talking about five or six cents?

Mr. Martini. Yes. That would probably work out, but you are not talking about much money. You are only getting $68 million now from table wine.

Senator Daschle. Do you have any opposition——

Mr. Martini. I oppose excise taxes period. I do agree with Mr. Metz. I have a problem with the regressiveness of it. I don't believe personally that excise taxes should be used for instrumenting social change. That is the way I look at things.

Senator Daschle. I think that if there is a change here, the change ought to be considered in one of two ways, either in changing the formula or changing the rate.

I frankly think that there may be some cause for considering changing the rate. I am not sure changing the formula at this time, given the dramatic consequences that would have on a bottle of wine, ought to be considered.

But I really think in the interest of the industry that that ought to be a position that you would want to consider.

I would like to ask Mr. Whitley, if I could, what the tax on a carton of cigarettes is today.

Mr. Whitley. Senator Daschle, I testified, I believe, before you arrived that the average nationwide tax on a package of cigarettes—which, as you know, is one-tenth of a carton—the tax on that package is 38 cents for a package of 20 cigarettes.

Cigarettes are the most taxed product in the country.

Senator Daschle. What is the floor component right now?

Mr. Whitley. What is what?

Senator Daschle. The floor component.

Mr. Whitley. I am not certain what you mean.

Senator Daschle. I understand that when we had an excise tax increase in the past, there was a floor tax component.

Mr. Whitley. Oh. Well, you are talking about the 1955 rate and inflation since that time and so on and so forth.

We would point out that, if you just look at the Federal excise tax alone and ignore the fact that State and local governments have taxed this product extremely heavily, then you don't keep pace with inflation.

But if you look at the original index on Federal excise tax and project it to the present, you come out with something like 34 cents a pack; and the total combined excise taxes on a pack of cigarettes today is 38 cents a pack.

Senator Daschle. That is the difference in the calculation of the floor component or the addition beyond the floor?

Mr. Whitley. If you project from the floor until today, the increases that have been brought about, you would wind up with about 34 cents a pack.

Senator Daschle. I see.

Mr. Whitley. And actually, the combined Federal, State and local today is 38 cents a pack; and again, cigarettes are the most taxed product in the country.

Mr. Myers. Senator Daschle, could I just add a point to that, because you came after our discussion of that?

There are a couple points that I think are worth noting. When you take into consideration the Federal, State, and local taxes, taxes on cigarettes today are substantially lower than they have historically been.

Between 1954 and 1973, taxes on cigarettes—when you consider all levels—never fell below 46.6 percent of a pack. Today, they are down to less than 34 percent of a pack, when you take into account all the State and local tax increases and the one-time increase the Federal Government imposed several years ago.

When you just look at the Federal tax share of it, it has dropped even further because there has only been one increase in the tax on cigarettes since 1951.

The Chairman. Mr. Myers, you will have to summarize because your time has expired. Senator Riegle?

Senator Riegle. This has been a very interesting discussion this morning, and I want to pose a couple of questions in a moment.

Certainly, alcohol and tobacco abuse, which goes on on a wide scale in our society, is a major problem. I served previously in the Senate as the Chairman of the Alcohol and Drug Abuse Subcommittee, and we had a chance during that period of time to really look at the scope of that problem.

In fact, Ms. Lubinski was a part of the effort at that time and I welcome you to the committee today.

Having said that, I think there is a real question as to whether we should connect the problem of alcohol abuse with tax policy, and whether we ought to address our concerns—legitimate concerns—about health related issues and practices with the way we distribute the tax burden in the country.

In fact, we have done it. At the State and Federal levels, we have connected the issue of excise taxes on alcohol and tobacco with social policy considerations. Whether fully justified or not, it is obvious that there has been a nexus established. That is the policy foundation from which we start.

But trying to find revenues to reduce the huge Federal budget deficit is such a large and difficult task that I am troubled by the notion that any single part of the society should bear that burden alone or that consumers of one kind of product or service should be the ones to take on a disproportionate share of the burden.

So, I think there is a legitimate question of fairness here, and it is a very hard one to resolve.

I am interested in something I was told the other day I would like to know what data the panelists are aware of that suggests that we may be, as has been asserted by some, approaching the point of diminishing returns on excise taxes in certain areas, in the sense that if we drive the price or the tax burden up much further, we may actually have the effect of reducing the total amount of revenue.

In other words, we get a certain amount from those taxes now, based on the volume of sales of that item that carries the tax; but if we were to raise the tax much higher, we might actually see enough of a falloff in the volume of sales that the Government would actually take in less revenue than it is getting at the present time. It would be self-defeating if, in raising taxes, sales would be sufficiently reduced that Government revenues actually declined.

I don't assert that we are now at this point, but some have said that we are. And I am wondering if any of you have studies that in a sense would move us away for the moment from the question of the social policy question to the sheer economics of whether or not we can, in fact, increase revenue by raising excise taxes. Or are we close to a point, or at the point, of diminishing returns on the application of excise taxes?

Do you have any data? Mr. Whitley.

Mr. WHITLEY. Senator, I don't have data to submit. I will be glad to submit some for the record; but our experience following the doubling of the cigarette excise tax just a few years ago from 8 cents to 16 cents very definitely showed a decline in sales.

And in addition to that, our experience was that the individual States, in anticipation of a decline in sales—which would in fact bring them a lower level of revenue—increased their own excise tax to ensure that they continued to bring in the same level of revenue.

We think the same thing would happen again. We can't tell you exactly where that point of diminishing returns becomes critical, but we think we are rapidly approaching it where the cigarette industry is concerned; and our past experience following the doubling of the excise tax indicates that.

Senator RIEGLE. I would like whatever data you have.

Senator RIEGLE. Mr. Myers?

Mr. MYERS. Let me make four points because there is data available. I would happy to provide you with a series of studies that were done by Harvard that seemed to indicate—at least with regard to cigarettes, and that is all they focused on—we are nowhere near close to that line at this point in time.

The 1982 increase resulted in overall a decrease of around four percent decrease in consumption. So, the amount of revenue that came into the Federal Government continued to rise very, very substantially.

Senator RIEGLE. Do you know what that figure is? You know that the usage dropped by four percent, but in terms of the revenue, do you know what the percentage is?

Mr. MYERS. Yes; I do have some figures, if you can give me just one second. I can give you those figures. My recollection was—and I will give you the exact figures—that Federal revenues increased from 1983, approximately $2.5 billion extra dollars.

Senator RIEGLE. And what would that have been as a percentage off the base? Do you have a sense for that?

Mr. MYERS. It is just slightly less than just double the amount of money the Government was receiving before.

Senator RIEGLE. Would that be a 100 percent increase in revenue?

Mr. MYERS. Not 100 percent, but very substantial.

There are two other points I would make just very, very briefly.

We all expected State revenues to fall after 1982; and what we found was that, given certain State increases in rates, State revenues actually have increased steadily rather than falling, telling us again that we are relatively far away from the point where you are going to see a decrease in consumption so substantial as to result in a decrease in revenues.

There is one last point that is particularly interesting and may be particularly telling. It is not an economist study; it is real-life experience.

In the last 12 months, the cigarette manufacturers on their own have increased the price of cigarettes three different times at the wholesale level for a total increase of 16 percent.

They obviously did it assuming and believing that that would result in increased profits.

The CHAIRMAN. Gentlemen, your time has expired, and we have two more panels. This has progressed very well, and it has been most helpful to us. We are most appreciative of that. We will forego further questioning because of time limitations. Thank you very much for your attendance.

Our next panel will be Mr. William Osterman, Chairman of the Board of Osterman Jewelers; Mr. Thomas Donahue, President of the Coalition Against Regressive Taxation; Mr. Robert Greenstein, Executive Director of the Center on Budget and Policy Priorities; and Mr. Bennet Miller, President of the Tri-County Telephone Company; Mr. Edward O'Brien, President of the Securities Industry Association; and Mr. Alger Chapman, Chairman and CEO, Chicago Board Options Exchange.

Gentlemen, we are pleased to have you. We have a five minute limitation on presentations. Your testimony will be taken in its entirety for the record; and we will start with Mr. William Osterman, the Chairman of the Board of Osterman Jewelers. Mr. Osterman?

STATEMENT OF WILLIAM N. OSTERMAN, CHAIRMAN OF THE BOARD, OSTERMAN JEWELERS, ON BEHALF OF THE JEWELRY COORDINATING COMMITTEE, INC., SYLVANIA, OH, ACCOMPANIED BY MATT RUNCI, EXECUTIVE DIRECTOR, THE MANUFACTURING JEWELERS AND SILVERSMITHS OF AMERICA, PROVIDENCE, RI

Mr. OSTERMAN. Good morning, Mr. Chairman and gentlemen. I appreciate the opportunity to speak with you this morning. I am William Osterman, the Chairman of the Board of Osterman Jewelers. We are a 52-store contemporary jewelry chain based in Toledo, Ohio.

Accompanying me this morning is Mr. Matt Runci, who is the Executive Director of the Manufacturing Jewelers and Silversmiths of America.

I will not read my statement but do request that my statement be included in the record.

I represent the Jewelry Coordinating Committee, which in turn represents over 12,000 jewelers, over 2,400 manufacturers of jewelry, and in excess of 150,000 employees throughout the 50 States.

Why should excise tax be rejected on jewelry? First, it does not "soak the rich and the well-to-do." As a matter of fact, most jewelry is purchased by blue collar and white collar workers.

A return to a tax which tax experts for decades have agreed to be a bad policy is totally unfair.

Let me quote, if I might, and this is from the 1965 House Ways and Means Committee Report when, finally in 1965, the excise tax on jewelry was repealed, having initially been put on first in 1941 and increased in 1943. I quote:

> A selected system of excise taxes places discriminatory tax burdens on the consumers and producers of the tax products.

And yet a second quote:

> Selective excise taxes tend to reduce sales and therefore reduce incomes and jobs in the industries which produce the taxed goods.

The cost to administer this, from a jeweler's point of view, is a nightmare. As a matter of fact, it is going to cost the United States Government a considerable amount of money to collect the tax.

So, between the difficulty the jeweler is going to have in collecting the tax from the consumer and the problems the Government is going to have in getting the taxes from the jeweler, the two combined is going to prove that it will hardly be worth the effort, plus the fact that it also opens the door to tax avoidance—from the ethical jeweler's point of view and quite frankly, tax evasion from an unethical opportunist.

The underground economy will be fraught with the opportunities provided.

The tax is highly discriminatory against one industry; and quite frankly, it will cause consumers to purchase items other than jewelry, items not subject to tax.

Let me give you a little history on that one.

I started work in this business when I was a kid, and I was behind the counters in the early 1940s and the 1950s and the 1960s when this tax was applied.

We had one devil of a time convincing the consumer that he or she had to pay a Federal excise tax over and above the price on the item.

Argument after argument, deal after deal had to be made in order to get the tax from the consumer; and quite frankly, in our own company, we had to put in many items other than jewelry to reach some kind of a reasonable volume just to continue to exist.

From 1945 to 1965, bear in mind that this tax was supposed to have been relieved on jewelry in 1945 with the cessation of hostilities. That didn't take place until 20 years later in 1965.

In that period, during the economic recovery, the jeweler did not fare nearly as well as most other retailers during this economic period.

And believe you me, it is not a luxury. Take the young girl who wants a diamond engagement ring. She has wanted this ring all her natural-born life. When she finally gets it, it is not a diamond ring for thousands of dollars, rather it is something for several hundred dollars.

And the guy who buys it for her limits the amount of money that he wishes to pay; so, diamond engagement rings sell for maybe $600 to $700.

The relationship to a wedding is very modest. The average wedding is $5,000 to $6,000; the diamond ring is $500 to $600.

What about a watch? It is a necessity. You gentlemen wouldn't be here today on time had you not had watches or clocks by which to judge the time to come here. [Laughter.]

Jewelry is bought by everyone, and most of the people who buy it have incomes anywhere from $10,000 to $30,000. We enjoy paying our taxes as jewelers—our income taxes.

We don't want to pay a regressive tax; and the job loss is dramatic. In the State of Rhode Island alone over the last 12 years, 10,000 jobs in their major industry, which happens to be the manufacturing of jewelry, have been lost.

One other point on luxury—the wedding band, which the girl and the guy each wear is not only a symbol of the unending love that one has for another; it also acts very practically. When the guy or gal who is married goes out singly, they like the other people to know that their girl is attached or their guy is attached.

The CHAIRMAN. Thank you very much, Mr. Osterman. Your time has expired.

Mr. OSTERMAN. Please reject the tax. Please reject this tax. Thank you.

The CHAIRMAN. Mr. Donohue, the President of the Coalition Against Regressive Taxation.

[The prepared statement of Mr. Osterman follows:]

HEARINGS ON REVENUE INCREASE OPTIONS
BEFORE SENATE FINANCE COMMITTEE

Summary of Statement of William N. Osterman
on Behalf of
Jewelry Coordinating Committee, Inc.
July 16, 1987

The Jewelry Coordinating Committee, Inc. represents 12,000 retailers and 2,400 manufacturers employing 150,000 people in 50 states. The Committee opposes the proposed ten percent excise tax on jewelry. The proposed excise tax is unfairly selective and will impose discriminating tax burdens on producers and consumers of jewelry. Such a tax will distort buying patterns by discouraging the purchase of jewelry in favor of untaxed articles of comparable value. It will discriminate against the jewelry industry for no justifiable purpose. There are no shortages of materials or national security needs to be satisfied by such a tax, and there are no sumptuary purposes to be met since jewelry is not monopolized by the rich.

The excise tax will further depress an already depressed industry by reducing sales, thereby reducing production, income and jobs. It will also create major administrative and compliance costs which will have to be met by retailers, many of which are small businesses. The proposed threshold level will add to the administrative burdens and will encourage tax avoidance. The Federal government will have to engage in vigorous audit and enforcement of the program, thereby creating high administrative costs, all for no discernable purpose. Such a tax will ultimately produce only a relatively small amount of revenue. The tax has no merit and should not be reimposed.

HEARINGS ON REVENUE INCREASE OPTIONS BEFORE SENATE FINANCE COMMITTEE

Testimony of William N. Osterman
on Behalf of
Jewelry Coordinating Committee, Inc.
July 16, 1987

I am William N. Osterman, Chairman of the Board, Osterman Jewelers, 5855 Monroe Street, Sylvania, Ohio 43560. My testimony today is on behalf of the Jewelry Coordinating Committee, Inc., an industry group representing 12,000 retailers and 2,400 manufacturers employing over 150,000 people in all 50 states. Members of the Committee include the Manufacturing Jewelers and Silversmiths of America, Inc.; Jewelers of America, Inc.; American Watch Association; America Gem Trade Association; and the Writing Instrument Manufacturers Association.

I am here today to present the industry's position on a proposed 10 percent excise tax on jewelry (including precious metal and costume jewelry), various precious and semi-precious stones, watches, clocks, sterling silver, and silver-plated, gold or gold-plated holloware and flatware. All these items will be referred to collectively as "jewelry" in this testimony.

Selective retail excise taxes (including those on jewelry) were imposed as temporary, emergency wartime measures in the early 1940's as a means to divert unnecessary expenditures and to supplement necessary wartime revenues. However, these so-called "temporary" taxes were not repealed until June 1965.

At that time this Committee's Report set forth among others, the following reasons for repeal:

> - A selective system of excise taxes places discriminatory tax burdens on the consumers and producers of the taxed products.
>
> - Selective excise taxes tend to reduce sales and therefore reduce incomes and jobs in the industries which produce the taxed goods. S. Rept. No. 324, 89th Cong., 1st Sess. 15 (1965).

What was true twenty years ago is still true today.

Your Committee files are replete with carefully prepared economic studies detailing the inequities and distortions created by such taxes on the distribution of affected products, the adverse effects on industry employment, the problems associated with compliance, and the questionable cost effectiveness of enforcement.

The following are the current views of the jewelry industry as to why an excise tax on jewelry should not be reimposed.

ECONOMIC DISTORTIONS AND DISCRIMINATION

As a selective federal excise tax, a retail tax on jewelry will cause distortions in buying patterns and will be highly discriminatory against one industry. The tax will discourage the purchases of jewelry in favor of other untaxed articles of a comparable value and desirability. Imposing a selective excise tax on jewelry would unfairly discriminate against the jewelry industry, especially since so many true "luxury" items would not be taxed.

In addition, there is no need to discourage the consumption of jewelry at this time. There are no shortages of the materials used to make these products, nor is there a pressing national security need to be satisfied that would otherwise go unfilled in the absence of the tax. There are no social costs or externalities associated with the consumption of precious jewelry, so there are no sumptuary purposes to be met.

The old-fashioned "luxury" argument for an excise tax on jewelry is far out of date. Jewelry is not monopolized by the rich. For example, in 1986 49 percent of the gold jewelry purchased in the U.S. was by households with incomes of less than $30 thousand; only 17 percent was purchased by households over $50 thousand. Rising incomes have made the preponderant majority of jewelry items common consumer items. Further, most reasonably priced jewelry articles are not normally perceived in the luxury category.

Also, if the idea of a so-called "luxury" tax is to solve some of the distributional problems created by the inherent regressive nature of excise taxes in general, it should be kept in mind that jewelry is bought by purchasers in all income brackets. The impact of this tax will, in large part, fall on the very same people who purchase other items such as cigarettes, liquor and beer which are also being considered for excise tax increases, and not necessarily on upper income purchasers.

EFFECTS ON A DEPRESSED INDUSTRY

An excise tax on jewelry would depress an already depressed domestic industry. Since the excise tax will be passed on in most instances to retail purchasers, sales will be reduced. This will cause reduced production by manufacturers which will result in a further decline in employment in an industry which has lost over 15 percent of its workforce over the past 10 years. It is particularly ironic that at a time when this industry is staging somewhat of a comeback because of the effects of the weaker dollar, the Congress would be considering levying a retail excise tax that could neutralize those gains.

COSTLY TO ADMINISTER

Any such excise tax would create major administrative and compliance costs. The burdens of collection, recording and transmitting this tax would fall on the shoulders of thousands of retail establishments which would be required to collect the tax on millions of transactions. Such burdens would be relatively heavier for the small, as opposed to the larger, retail outlet. In its report on the 1965 legislation, this Committee stated:

> In all, it is believed that 100,000 to 200,000 retail outlets are involved in the collection of this tax. The compliance burden imposed by the tax is often a severe one in an industry which contains a large number of small, one-family concerns. S. Rept. No. 324, 89th Cong., 1st Sess. 17 (1965).

Introduction of any threshold level would further complicate these administrative chores and simultaneously opens wider possible avenues for tax avoidance, not because of dishonesty, but primarily as a consequence of the prevailing market pressures to keep prices as low and as attractive as possible to the potential consumer.

A tax with a dollar threshold would result in widespread, legal but uneconomic methods of avoidance. For example, earrings could be sold one at a time on separate days. Silver flatware could be divided up into several purchases just under the limit. It would be foolish for the federal government by tax policy to force this type of uneconomic consumer activity.

To assure that this tax avoidance is held to a minimum, the federal government would have to engage in a fairly vigorous audit and enforcement program. In turn, this would sharply increase the compliance costs to the government. Experience in this and other countries has clearly indicated that the high levels of these costs are major disadvantages to the use of excise taxes. It is not too difficult to foresee the cost and confusion on the part of the consumer, the retailer, and the Internal Revenue Service to achieve some sense and order out of this entire excise tax area. I trust that you agree with me that this administrative morass is unnecessary.

SUMMARY

To sum up, there appears to be little merit in a ten percent retail excise tax on jewelry sales beyond its ready accessibility as an easy target for a tax. Thus, any proposed retail excise tax on jewelry should be rejected. It is very bad tax policy. It will cause economic distortions in the consumer market. It is highly discriminatory. It will be costly to administer, both to the government and the industry. It will produce a relatively small amount of revenue. It will depress an already depressed industry. It would be a return to a tax which experts for decades have universally agreed was bad tax policy, and for that reason alone should not be reimposed.

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STATEMENT OF THOMAS J. DONOHUE, PRESIDENT, COALITION AGAINST REGRESSIVE TAXATION, WASHINGTON, DC

Mr. DONOHUE. Thank you, Senator. That is a very difficult presentation to follow. I am Tom Donohue, President of the American Trucking Associations, and President of the Coalition Against Regressive Taxation, an alliance of companies and trade associations from a variety of industries whose customers, workers, and owners—many of them small businesses—pay the bulk of the Federal excise taxes.

To put it very bluntly, I represent a group of industries that make, sell, or use products that some people feel should be taxed very heavily.

Before you decide to increase these excise taxes on fuel and tobacco or alcoholic beverages, I think you should focus on the fact that you are not taxing beer, but beer drinkers; not trucks, but owner-operators and family trucking businesses; not cigarettes, but tobacco farmers, workers, and mom-and-pop grocery stores; and not wineries, but the thousands of families who by choice or tradition drink wine as a part of their meals.

Now, we have a series of very specific reasons why we oppose these excise taxes.

First, as has been discussed here this morning, they are regressive, and the study which was done by the Peat Marwick people for our coalition—which Mr. Chairman, if it has not already been placed in the record, I would hope we could pass it on——

The CHAIRMAN. We will be pleased to have it.

Mr. DONOHUE. Thank you. Basically, it points out that for people at $10,000 and under, they lose five times the value of what they gained out of tax reform; and those making $20,000 and under would have 136 percent increases in the taxes they pay.

Second, we say these taxes discriminate by region and geography. The per capita use of gasoline is two times higher in Indiana, Kentucky, and South Dakota than it would be in New York.

It hurts those who drive to work and those who work in regional industries, such as beer, tobacco, wine, and trucking.

The third point we have is that they burden workers and proprietors in a few industries, as opposed to all the industries that would be affected by the nation's deficit—tourism, trucking, wine and beer, airlines, distilled spirits.

They operate in selected areas of the country and would be therefore discriminated against in terms of employment, in terms of standard of living, and the other matters which have been discussed this morning.

Fourth, we say they discriminate against groups of consumers, that is to say that a selected group of consumers would pay for the deficit reduction for all citizens—those that work in my business—in the trucking business—those that drive to work, minorities, unfortunately, and others would be adversely affected in a disproportionate way.

And fifth—very important—they jeopardize State finances.

If you look at what has happened in the highway tax area in the States, if you look at what has happened in other excise taxes, you will find that States that have been struggling since the changes in

Federal support of State activities are beginning to depend more and more on taxes that are related to excise collections.

And we think that those States would be hurt.

Again, just going back to my own experience in the gasoline area and the diesel fuel area, we have 22 States this year that either have or are in the process of raising their excise taxes.

Mr. Chairman, I would quickly sum up because I know your time is short today by saying that we feel these taxes take away the benefits of the Tax Reform Act, which was passed just a year ago and which we supported and we believe is moving us in a direction of a sounder economy and a fairer tax system in this country.

Second, and a very important issue—and I have not heard it discussed very much this morning—is the question: Can they be passed on? Are they not just immediately passed on to the consumer?

I think there are two points here. Yes, eventually, they do get to that consumer who is going to be affected in a regressive way; but along the way, they are very harmful, particularly to small businesses that need to hold those taxes in a competitive environment where they cannot raise them against perhaps larger companies, or they can't raise their prices.

And second, they have to hold them until the occasion comes when they can raise their price; and in the process of doing that, particularly small companies will be hurt.

And the final two points I would make, gentlemen, is that the Federal deficit is the responsibility of all Americans, and we have to face up to it, both in the manner of how we spend our Federal money and how we collect our Federal taxes.

And we should not select out individual groups of consumers to pay for the rest of it.

The final point that I would make is that obviously we would all suggest that the way to resolve our Federal deficit is by cutting spending.

After you get through that argument and the reality that the spending cuts are difficult to address and Social Security and defense and entitlements and other matters, you come to the question, and you have obviously asked this all morning: If you are not going to do excise taxes, what are you going to do?

I think without naming a tax, at least in my presentation, I think it is important that, if there is going to be a tax, that I pay as much of it as does the farmer or the truck driver or the consumer of beer, wine or alcohol who is at a much lower income situation.

Quite frankly, none of us here today is going to be affected if the price of gasoline goes up by a few cents, the price of wine or liquor or other commodities; but those who use them and who are in a much lower income bracket will be seriously affected.

Thank you very much.

[The prepared written statement of Mr. Donohue follows:]

Coalition Against Regressive Taxation

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BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE

Statement on Behalf of
COALITION AGAINST REGRESSIVE TAXATION

HEARING ON
REVENUE-RAISING OPTIONS

July 16, 1987

Thomas J. Donohue
President and Chief Executive Officer
American Trucking Associations

My name is Thomas J. Donohue; I am President and Chief Executive Officer of the American Trucking Associations (ATA), the national federation representing all types and sizes of motor carriers.

SUMMARY

This statement is presented on behalf of the Coalition Against Regressive Taxation (CART). CART is an alliance of companies and trade associations from a variety of industries whose customers, workers, and owners, many of them small businesses, pay the bulk of federal excise taxes. CART does not have a formal membership, but attendees at our recent meetings have come from more than 30 companies and associations that are affected by excise taxes on tobacco, beer, wine, distilled spirits, and highway and airways users.

Participants in CART are united in their opposition to increases in excise taxes as a means to reduce the deficit, whether these taxes go into general revenues, existing trust funds or some type of "deficit reduction trust fund." We oppose these increases for five reasons:

- o They are regressive and undermine tax reform. Families with incomes below $5000 pay from seven to 15 times as great a fraction of income for federal excise taxes on gasoline, beverages and tobacco as do families with incomes exceeding $50,000, according to the Congressional Budget

Office (CBO). A more recent study by the Policy Economics Group of Peat Marwick shows that even a $4-5 billion excise tax increase could wipe out the relief promised by tax reform to families with incomes below $10,000.

- They discriminate by region. For instance, per capita gasoline use in Indiana is double that of New York. Tobacco, wine, beer, and distilled spirits taxes each fall on farmers and manufacturing workers in a small number of states. These inequities are especially inappropriate when a tax is increased for a purpose that is everyone's responsibility. such as deficit reduction.

- They discriminate against narrow groups of consumers. Fuel taxes fall most heavily on those who must drive long distances for work or other nondiscretionary purposes. Tobacco and beverage taxes hit products whose consumers are disproportionately from minority and lower-income groups.

- They burden workers and proprietors in a few industries. A diesel tax falls hardest on owner-operators and on workers and owners of marginal trucking companies, mostly small businesses. Tax-induced cutbacks in gasoline consumption hurt many travel and tourism-related businesses, as well as service stations and oil distributors. Reduced sales of beverages and cigarettes that result from tax increases hurt "mom and pop" stores most, along with growers, producers, and distributors of the respective goods.

- They jeopardize state finances. Highway users, including the trucking industry, have generally supported use of fuel taxes at the state level to finance road building and repair. Increases in federal taxes that have historically gone to the Highway Trust Fund will reduce state highway user revenues, preclude some states from enacting needed increases, and break the link at both federal and state levels between this revenue source and use of funds.

Individual participants in CART may have their own preference for how to accomplish deficit reduction. CART as an organization does not take a position on issues other than excise taxes.

REGRESSIVITY AND UNDERMINING TAX REFORM

The evidence that excise taxes are regressive and contrary to the intent of the Tax Reform Act is overwhelming. In January, a CBO staff working paper found, "The average increase in [excise] taxes as a percentage of total income would be about twice as large (more than three times as large in the case of the tax on beer or tobacco) for families with incomes between $10,000 and $20,000 compared to families with incomes of $50,000 or more." ("The Distributional Effects of an Increase in Selected Federal Excise Taxes," p.2)

In May, CART released a study it had commissioned from a leading independent researcher, Policy Economics Group of Peat Marwick. That report, "An Analysis of the Regressivity of Excise Taxes," which has been submitted for the record, confirms recent CBO findings on the regressivity of gasoline, tobacco, beer, wine, and distilled spirits taxes. It also shows how quickly increases in these taxes would overwhelm the relief for low-income families that was promised by the Tax Reform Act of 1986.

The study assumed for illustrative purposes that the fiscal 1988 revenue target would include $18 billion from the five excise taxes listed above. This would result in a near-doubling of each tax. Using a data base and methodology comparable to that of the Joint Committee on Taxation and CBO, the report found that this package would produce a tax increase for families with less than $10,000 of income nearly five times as great as the tax relief enacted last year.

That income group is estimated to receive income tax relief totaling $414 million once the Tax Reform Act becomes fully effective. The excise tax increase would total nearly $2 billion. Even a tax increase of just 5¢ per gallon for gasoline, or a comparable rise of $4-5 billion in the other excise taxes, would eliminate any tax savings for this income class.

Another recent report, "Meeting the Revenue Targets in the 1988 Budget: Will Tax Reform Be Extended or Undermined?" (May 1987), by Citizens for Tax Justice (CTJ), also confirms how unfair excise tax increases would be for the group least able to pay.

The regressivity cannot be cured merely be increasing the earned income credit. That credit only reaches families with earned income and does not help those who are retired or unemployed. Moreover, the credit bears no relation to individual consumption patterns, which is essential to compensate for taxes on selected consumption items. Other solutions quickly become far too expensive and/or complex. In short, the only "fix" for the regressivity problem is to avoid increasing excise taxes altogether.

DISCRIMINATION AGAINST SELECTED POPULATION GROUPS

The CBO and other studies make the conventional assumption that the full amount of an excise tax increase would be passed through to consumers in proportion to their current consumption of taxed products. In fact, as the CBO study points out, there are a variety of effects, depending on the degree to which the taxes are passed forward. Unfortunately, the complete picture is more complex but no more comforting: under any set of assumptions, these taxes hurt those least able to pay.

Besides discriminating against the poor, these excise taxes vary greatly by region, demographic characteristics, occupation, and industry. There is no justification for such inequities when the goal is a national one such as deficit reduction, which should be borne by all taxpayers.

The degree of pass-through varies by elasticity of supply and demand for each product. For instance, in trucking, competitive conditions have prevented most firms from passing through the 15¢ increase in diesel prices that has occurred since last winter. A similar tax increase would be equally hard to pass through, and many owner-operators and marginal companies would be driven out of business before prices rose enough to cover the cost of the tax.

There would be geographic discrimination. Gasoline and gasohol use per capita in Indiana, Kentucky and South Dakota is roughly double that for New York, Hawaii and the District of Columbia, according to the Highway Users Federation. As a percentage of income, the CTJ report shows that a gasoline tax would fall most heavily on southern and western states. Within states, the tax discriminates against rural and small-town residents, who do not have the option of public transit and often must travel long distances for any purpose.

Farm production of crops used for cigarettes, beer, wine, and some distilled spirits is likewise concentrated in a few states--indeed within limited regions of those states. Winery, distillery, and tobacco factory workers, who along with farmers would bear the brunt of tax-induced cutbacks in demand, are also geographically concentrated. Many have limited alternative job prospects.

The demographic implications of these taxes are also unsavory. The gasoline tax singles out large families that require larger and less fuel-efficient vehicles. It also targets those who depend on an automobile for their livelihood, either for their own job or because they work in travel, tourism, fuel, or automotive service fields. Other taxed products are used disproportionately by minority groups.

Job losses from increasing these taxes are likely to be highest among small businesses. For instance, in trucking, it is the owner-operator and the marginal, usually small, company that will have the most difficulty absorbing or passing on an increase in diesel taxes. "Mom and pop" stores are the most dependent of any outlets on sales of tobacco and alcohol beverages and the most sensitive to tax-induced cutbacks in consumption. Similarly, the small roadside or corner auto-related business is far more vulnerable than the large oil or vehicle producer to effects of a gasoline tax hike.

Some proponents of higher excise taxes try to mask their proposals as public health measures. But these arguments are incomplete and misleading. For instance, when the cigarette tax was doubled in 1982, an estimated 14,600 tobacco growers and workers lost their jobs; that cost must be weighed against any assumed health benefits. As another example, the vast majority of those who consumer beer do so moderately. The tens of millions of Americans who drink beer responsibly, without exacting any cost on society, should not be penalized for the abusive behavior of a small minority. And to argue that the small minority of abusers of beer or other alcohol beverages will refrain from abuse as a result of higher taxes is nonsense.

EFFECTS ON STATE FINANCES

Several industries represented in CART pay even more in state excise taxes than in federal ones. States have been turning increasingly to excise taxes as a source of added revenues. For instance, in the past 30 years, state excise taxes on beer have increased by approximately 600%. From 1982 to January 1987, state diesel fuel taxes have risen 36%; this year 18 states have put increases into effect, with several others pending. (This is on top of a 275% federal diesel tax increase since April 1983.) Since fiscal 1981, 38 states have raised their cigarette taxes (and the federal tax has doubled). Distilled spirits taxes gave been raised in 41 states since 1980 (and the federal tax went up 19% in 1985). In the same period, 36 states have enacted wine tax increases. (Details on these changes are available from CART.)

Increases in federal excise taxes will reduce consumption and hence state revenues. Increases may also preempt states from increasing the same taxes. Moreover, for taxes that have historically gone into highway or other trust funds, the use of that revenue source for general revenues at the federal level is a damaging precedent at both federal and state levels. It is no wonder, then, that a wide range of organizations representing officials of state, county and municipal governments has opposed one or more federal excise tax increases.

ALTERNATIVES

CART takes no position on proposals other than increases in excise taxes. Each member may have its own position. For instance, the trucking industry does support improved collection procedures for the diesel tax. Currently, $300 million a year, according to Federal Highway Administrator Ray Barnhart, and much more according to other estimates, of this tax is not being collected. The trucking industry is generally paying this tax at the pump, and wants to make sure that the money gets into the Highway Trust Fund instead of being siphoned off.

CONCLUSION

All of the options presented to the committee for raising excise tax rates are unacceptable for the reasons stated above. These objections apply whether the rate increase is explicit or disguised as indexation, equalization, or implicit income tax offsets.

CART's business members have been joined in their opposition by an unusual assortment of interest groups, representing labor, consumers, minorities, and state and local governments among others. We believe this breadth of opposition is further strong evidence of the error of increasing excise taxes.

The CHAIRMAN. Our next witness is Mr. Robert Greenstein, who is the Executive Director of the Center on Budget and Policy Priorities, testifying on behalf of the Children's Defense Fund and others. If you would proceed, sir?

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, TESTIFYING ON BEHALF OF THE CENTER AND THE CHILDREN'S DEFENSE FUND

Mr. GREENSTEIN. Thank you, Mr. Chairman. As you just mentioned, this testimony is offered both on behalf of the Center and the Children's Defense Fund, both of which organizations are very concerned about low and moderate income families.

Both organizations were active members last year of the 15/27/33 Coalition, and I think the two most active organizations from the low income area that strongly supported the Tax Reform Bill.

The CHAIRMAN. Would you further identify the Center that you are referring to?

Mr. GREENSTEIN. Senator, that is the Center on Budget and Policy Priorities, of which I am the Director, which is nonprofit research and analysis organization focusing on public policy issues affecting low and moderate income people.

The CHAIRMAN. Thank you.

Mr. GREENSTEIN. In addition to strongly supporting last year's Tax Reform Bill, we also strongly support the need to raise revenues and to reduce the deficit.

We recognize that the Committee has difficult choices this year. We hope that the Committee raises revenues in a fashion that doesn't place an undue burden on those with low and moderate incomes; and, accordingly, we would urge that excise taxes, including those on energy, constitute no more than a modest part of your revenue package.

If excise taxes are included, we would urge the Committee to offset their aggressive nature by taking additional actions in the low income area such as adjusting the earned income tax credit.

The primary objection to excise taxes is their imposition without regard to ability to pay. Because of their regressivity, they could cost low and moderate income families a significant portion of the tax relief they won last year.

And so, we urge the Committee not to rely too heavily on excise taxes.

Having said that, we would like to note that not all excise taxes are created equal. In the appropriate context, some excise increases are acceptable notwithstanding their regressivity; in particular those excises levied on discretionary items that have beneficial deterrent effects, such as excises on alcohol and tobacco, we think would be appropriate.

We think there is much less positive to be said for other excise taxes such as the telephone excise tax, since the telephone is a necessity, and energy excise taxes since all low income people have to consume energy.

So, we hope the Committee will choose to have excises comprise as little of the revenue package as possible and choose among them with a careful eye to their consequences.

We recognize that excises probably will comprise a part of your package, and again, we very much want you to put together a package that hits the revenue targets and can pass, and we recognize excises may need to be a part of that. If so, we would urge you to take some action to offset their regressive nature, and we think adjustments in the EITC and/or the dependent care tax credit area would be the best ways to do that.

Adjusting the earned income tax credit by family size would be good social policy as well as good tax policy.

The CHAIRMAN. Mr. Greenstein, I have just a comment. Don't use acronyms. You and I live with them here, but we have the public interested and concerned. So, when you talk about the earned income tax credit, spell it out for us.

Mr. GREENSTEIN. Sorry, Mr. Chairman.

Adjusting the earned income tax credit by family size would not only be good tax policy, but good social policy. A full-time, year-round minimum wage job brings a family of two to the poverty line, but leaves a family of three $2,100 below or a family of four $4,400 below that line.

The poverty line is adjusted by family size. Welfare benefits are adjusted by family size. Wages are not.

As a result, trying to move families from welfare to employment creates a serious problem for large families. They may be considerably worse off if they go to work at a low wage job, and their children can be pushed deeper into poverty. The Tax Code compounds this problem.

It treats small and large low income families differently, even after tax reform. Small families with earnings at the poverty level pay no income tax and have most of their Social Security income tax—or payroll tax—offset.

Large families at the poverty level have much less of their payroll tax burden offset, and one of the main reasons for this is that the EITC—the earned income tax credit—does not vary by family size.

One of the most beneficial things Congress could do to encourage work and self-sufficiency would be to put in such an adjustment. It would bring working poor families with several children closer to the poverty line, substantially strengthen work incentives, provide for more equal treatment—tax treatment—of large and small families with children, and might also help with some votes for the bill because of offsetting the regressive nature of the excise taxes.

I would note that this concept—adjusting by family size—has been supported by Gary Bower in the White House Report on Families last November, Dan Crippen, Chief of Staff Baker's principal Budget Aide, the Heritage Foundation, Deputy Assistant Secretary of the Treasury for Tax Policy, Eugene Surly, and others.

Another option would be to increase the phase-in rate for the earned income credit from 14 to 15 percent. It has historically been set at double the rate of the payroll tax.

That was put at 14 percent. The payroll tax in effect when last year's Tax Reform Bill was written, is a little over 7 percent. In

1988, it goes up to 7.5 percent; and that should lead to a need to have the rate for the earned income credit be 15 percent of earnings for poor families.

Finally, the dependent care tax credit could be made refundable. That would allow working poor families who owe little or no Federal income tax, but do have child care expenses, to benefit from it.

It would be a nonintrusive way of increasing the affordability of child care for poor families and would also foster work incentives.

I would end by noting that these items are not mutually exclusive. They can be designed for almost any cost parameter you want, and most important—or very important—they have very little first year costs.

Most of the costs wouldn't show up until 1989. It would not have a material effect on your ability to hit the targets in 1988. Thank you.

The CHAIRMAN. Thank you very much, Mr. Greenstein.

Now, Mr. Bennet Miller, who is the President of the Tri-County Telephone Company. If you would proceed, sir?

[The prepared written statement of Mr. Greenstein follows:]

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Robert Greenstein
Director

TESTIMONY OF ROBERT GREENSTEIN

EXECUTIVE DIRECTOR

CENTER ON BUDGET AND POLICY PRIORITIES

on behalf of

THE CENTER ON BUDGET AND POLICY PRIORITIES

AND THE CHILDREN'S DEFENSE FUND

before the

SENATE FINANCE COMMITTEE

July 16, 1987

Mr. Chairman and Members of the Committee, we appreciate the invitation to testify here today. I am Robert Greenstein, director of the Center on Budget and Policy Priorities, a non-profit research and analysis organization that focuses on public policy issues affecting low and moderate income Americans. This testimony is also offered on behalf of the Children's Defense Fund, a non-profit organization which focuses on the needs of low income children and their families.

Just over two years ago, in June of 1985, we had the opportunity to testify before this Committee on proposals for comprehensive tax reform. At that time, we discussed the great need for tax reform for the working poor of this country. This need led us to support strongly the historic tax reform measure that this Committee drafted, and we regard that Act as perhaps the most significant legislative gain low income people have made over the past decade. The Members and staff of this Committee who labored long and hard to produce this achievement have much of which to be proud.

Today's issue, how to increase revenues in order to meet the reconciliation instructions of H. Con. Res. 93, confronts the Committee with many of the same hard choices it faced last year. We hope that the Committee's choices this year will be consistent with last year's bill. In particular, we encourage the Committee to raise these revenues in a fashion which does not place an undue burden on those with low and moderate incomes. This is of special importance as the Committee considers raising excise taxes, which fall more heavily on such individuals than they do on the population as a whole. We urge that excise taxes (including those on energy) constitute no more than a modest portion of the revenue package. If excise taxes are included, we urge that the Committee offset the regressive nature of these taxes by taking additional action, such as adjusting the Earned Income Tax Credit (EITC) by family size. I will discuss the concept of an offset, and various ways in which it might be accomplished, in greater detail later in this testimony.

I should note that we supported passage of the budget resolution and the resolution's mandate for additional revenues. We are concerned that Congress take action to reduce the current high level of the federal budget deficit, which we regard as a threat to the economy. In addition, the pressing social needs of the country will be difficult to address until this impediment is dealt with.

Our support for increasing revenues is consistent with our support of tax reform. Like many Members of this Committee, we had some concerns about enacting a major tax reform that did not reduce the deficit. Like the majority of this Committee, however, we believed that such a revenue-neutral reform was still quite desirable. And, like many Members of this Committee, we believed that enacting tax reform would put the country on a far sounder footing to then raise the revenues which might be needed to bring the deficit under control.

We continue in this belief today. Last year's Act clearly showed that Congress and the American people believe that federal revenues should be based on an ability to pay. Those with low and moderate incomes should not be faced with tax burdens they can ill afford. Further, in this age of high deficits, tax expenditures must be subject to the same tough scrutiny as direct spending. Tax credits, exclusions or incentives which distort economic behavior, benefit one form of investment over another with no overriding social purpose, or whose economic returns are small, if any, are an inappropriate allocation of scarce public resources.

As a first step, we encourage consideration of some of the base-broadening reforms which were included in the tax reform bill approved by this Committee in the spring of 1986 but which for one reason or another were not part of the final bill. We would also suggest that there remains much fertile ground for further reforms. The pamphlet prepared by the Joint Committee on Taxation contains no shortage of base-broadening reforms which would be perfectly consistent with last year's Tax Reform Act.

By contrast, it would not be fair to reduce the deficit on the backs of those with low and moderate incomes. This path has already been too well traveled. In the earlier part of this decade, large scale reductions in spending that fell disproportionately on those with low and moderate incomes were made in the name of deficit reduction. Though programs which serve low income people comprise only 10 percent of the federal budget, these programs suffered nearly one-third of all the cutbacks in spending enacted in 1981 and 1982. Low income Americans have already sacrificed more than other citizens to bring the deficit down. The serious human consequences of the cutbacks in low income programs have been well documented.

Less well appreciated is the significant erosion in tax fairness that has also victimized low and moderate income Americans in recent years. This erosion will be only partially rectified by last year's tax reform. At the federal level, there has been an increasing reliance on regressive payroll taxes. In addition, the Urban Institute has found that the cuts in federal taxes and services in the early part of this decade were a factor in leading states to increase their own taxes to deal with the added burdens. The Urban Institute found that this trend further adversely affected those with low and moderate incomes since state tax systems tend to be far less progressive than the federal system. Further, several recent studies, including one by the National Bureau of Economic Research (NBER), conclude that state tax systems themselves have grown more regressive over recent years. The overall result has been a flattening out of the nation's tax system, a result documented by Joseph Pechman of the Brookings Institution. Though last year's reform was certainly a large step in the right direction, it cannot hope to reverse these larger trends by itself.

Within the past three weeks the U.S. Census Bureau has released data which cast new light on this situation. These data show that the gap in after-tax income between the richest 20 percent of American households and the rest of the nation hit its widest point in 1985 (the most recent year for which these data exist). The poorest fifth of all households received only 4.6 percent of the nation's after-tax income, the smallest percentage Census has recorded since this data series began in 1980. At the same time, the after-tax income of the richest fifth increased significantly -- so that the top fifth received $34 billion more a year in after-tax income than it would have if it simply maintained the same share of national after-tax income that it had in 1980.

Moreover, between 1980 and 1985 tax burdens on households with incomes below $10,000 a year increased by nearly 19 percent, when measured as a percent of income. Despite the fact that federal income tax burdens were rising for these households over this period, the Census Bureau reports that the bulk of this increase was due to state and local taxes. As a result, the 1986 Tax Reform Act, though immensely helpful to low income families, will not cause a reversal in this basic trend.

Accordingly, excessive reliance on excise taxes as a means of reducing the deficit would exacerbate an already unsatisfactory situation. Our primary objection to excise taxes is that they are imposed without regard to ability to pay. As the recent Congressional Budget Office (CBO) examination of this topic confirmed, low and moderate income individuals would pay a substantially higher percentage of their incomes in increased excise taxes than would other taxpayers. Imposing such regressive taxation would be directly counter to the Committee's valiant efforts over the last two years to improve the fairness and progressivity of the tax system. In fact, increased federal excise taxes could cost low and moderate income families a significant portion of the tax relief that they won last year. We strongly urge the Committee not to rely too heavily on excise taxes as the means of raising new revenues this year.

Having said that, let us note that not all excise taxes are created equal. Our positions have long been that in the appropriate context, where all taxpayers were being asked to share the pain fairly, or where the revenues were being dedicated to areas of spending which we view as high priorities, there are certain excise tax increases which would be acceptable, notwithstanding their regressive effects. These are excise taxes which are levied on discretionary items and which have beneficial deterrent effects -- in particular, excise taxes on alcohol and tobacco.

Tobacco and alcohol use both impose costs on society. Increasing the taxes on these items would help compensate for those costs. In addition, increasing the taxes would cause consumption to decline, particularly among children and young adults. Stopping smokers before they start, and decreasing drinking among those most likely to be involved in alcohol-related traffic accidents, are exceptionally worthy social goals.

By contrast, there is little positive to be found in certain other excise taxes. What social goal is served be imposing a federal tax on telephone service, on top of a federally ordered line charge? Telephone service should no longer be thought of as a discretionary item, and such taxes and charges are regressive. An oil import fee, which would not only be highly regressive but which would cost consumers $3 for every dollar collected by the Treasury, is likewise objectionable. Even a broadly based energy tax, though much preferable to an oil-import fee, imposes a significant (and regressive) burden on low-income people for consumption which is largely non-discretionary.

We would recommend that the Committee retain the Federal Unemployment Tax Act (FUTA) at its current level. With the need for revenues so great, there is no overriding reason to go ahead with what amounts to a tax cut for employers. This is especially true given the need of this trust fund to build a level of cushioning. Prudent fiscal policy suggests taking advantage of the current economic recovery to lay the groundwork for dealing with the next recession.

Thus, we hope the Committee will choose to have excise taxes comprise as little of the revenue package as possible, and will carefully choose among various excise taxes with an eye towards their consequences. However, we recognize that it is likely that excise taxes will comprise at least some part of the revenue package. If so, we appeal to the Committee to consider taking some action to offset the regressive nature of such taxes.

Offsetting the regressive effects of excise taxes could be accomplished in any of a number of ways, involving action on either spending or taxes, or some combination of both: the particular option chosen would depend to some extent on the size of the offset necessary. However, an offset can be designed for almost any given amount. The initial parameter -- how large an offset is necessary -- would need to be determined by the Committee based primarily on how much reliance is placed on regressive taxes.

Increasing the Earned Income Tax Credit (EITC), altering it so that the size of the credit varied by family size, and making the Dependent Care Tax Credit refundable are tax actions that would target benefits to the working poor and thus partially compensate for the effects of increasing excise taxes. Balancing these taxes with targeted increases in expenditures would also be useful. Such offsets would help keep this year's measure consistent with the principles that guided last year's reform.

Adjusting the EITC by family size would not only be good tax policy, but good social policy as well. A full-time, year-round minimum wage job now brings a family of two to the poverty line, but leaves a family of three $2,100 below the poverty line and a family of four $4,400 below the poverty line. The poverty line is adjusted for family size, as it should be. A low income family's need is a function of it size, not just its income, and I think we would all agree that a family of four with $10,000 of earnings is needier than a family of two with the same income level. Welfare benefits are adjusted by family size as well.

But wages are not adjusted by family size. As a result, trying to move families from welfare to employment creates a serious problem for large families. They may be worse off if they work at a low wage job, and their children may be pushed deeper into poverty.

This differential treatment of large and small families is compounded by the federal tax code, even after tax reform. Small families with earnings at the poverty line now pay no income tax and have most of their social security payroll tax burden offset. But for large families with earnings at the poverty line, very little of the payroll tax burden is offset.

The reason for the differential tax treatment of large and small families is because, as currently structured, neither the nor the standard deduction nor the EITC vary by family size. Adding such a feature to the EITC would be one of the more beneficial things Congress could do to encourage work and self-sufficiency. Such an adjustment would bring working poor families with several children closer to the poverty line, substantially strengthening work incentives and also providing for more equal tax treatment of larger and smaller families with children.

These benefits of increasing the EITC for larger families -- and the attractive politics surrounding the fact that such a move is both pro-work and pro-family -- have made it an item called for by liberals and conservatives alike. On record as endorsing adjusting the EITC by family size are conservatives such as the President's Domestic Policy Advisor Gary Bauer (who called for adjusting the EITC by family size in the White House report on families issued last November), Dan Crippen (Chief of Staff Baker's principal budget aide), and the Heritage Foundation. Eugene Steuerle, Deputy Assistant Secretary of Treasury for Tax Policy and formerly of the American Enterprise Institute, also called for this action in an article written last year.

Another tax option whose merits are sufficient that it should be considered in any case, but which might also serve as an offset, would be to increase the phase-in rate of the EITC from 14 percent to 15 percent. This option is smaller in scope than adjusting the credit by family size, but such an increase is necessary to compensate for the effects of the scheduled rise in the FICA tax rate. The phase-in rate of the EITC has generally been set at double the rate of the FICA tax (since most economists believe that low wage employees actually bear the brunt of both sides of the payroll tax, employer and employee). The current FICA rate of 7.15 percent dictated the choice of 14 percent as the phase-in rate in last year's bill. However, on January 1, 1988, the FICA tax rate will increase to 7.51 percent, for a combined rate slightly above 15 percent. To offset the FICA tax most effectively, the EITC phase in rate should be boosted to 15 percent.

A third option is to make refundable the Dependent Care Tax Credit. This would allow working poor and near-poor families who are owe little or no federal income tax, but who nonetheless have child care expenses, to benefit from this credit. As a result of the Tax Reform Act of 1986, families with incomes below roughly 110 percent of the poverty threshold who have child-care expenses are the only child-care users who cannot benefit from this tax credit because they will have no tax liabilities and the credit is not refundable. Making this credit refundable would be a non-intrusive way of increasing the affordability of child care for poor families. As insufficient child care is a major impediment to work, such a move would foster work incentives and assist those poor families already working.

These items are not mutually exclusive. Indeed, they can be combined in various ways and have several important features in common. First, they target their benefits exclusively to low income working families. This makes them quite cost effective. Secondly, on the issue of cost, these items contain a hidden bonus – they would have a very small first year cost.

Almost all EITC costs, and all the cost of making the dependent care credit refundable, involve either refunds or reducing tax liability when tax returns are filed. As a result, most of the cost associated with increasing the EITC for calendar year 1988, or for making the Dependent Care credit refundable, will not be incurred *until 1989* and would entail relatively little revenue loss in FY 1988. Accommodating these costs in the out-years may not prove that difficult for the Committee. To reach $19.3 billion in revenue increases in FY 1988, the Committee may have to enact measures that exceed the revenue targets for the out-years. Thus, the Committee could include these offset options, and still not need to raise much more than the $19.3 billion figure for FY 1988 in order to reach the reconciliation targets.

Notwithstanding the desirability of offsetting the regressive effects of whatever excise taxes may be included in this revenue measure, we would not want to convey the impression that including an offset makes everything alright. Though including an offset makes things much less inequitable than they would otherwise be, significant numbers of the poor -- non-working elderly for example -- would be negatively affected by excise taxes but would receive no compensating offset. This could be partially corrected through targeted increases in spending in addition to action on the tax front. Otherwise, such individuals would disproportionately bear the brunt of deficit reduction, regardless of their demonstrable inability to do so. The ideal is still to construct a revenue package that is progressive from the onset. It would be unfortunate if one of the greatest gains of last year's reform -- the tax relief it offered to the poor -- was undone in whole or in part by this year's tax legislation.

STATEMENT OF BENNET MILLER, PRESIDENT, TRI-COUNTY TELEPHONE CO., TESTIFYING ON BEHALF OF THE UNITED STATES TELEPHONE ASSOCIATION, NEW RICHMOND, IN

Mr. MILLER. Thank you, Mr. Chairman. My name is Bennet Miller, and I am President of Tri-County Telephone Company, New Richmond, Indiana, and serve as Chairman of the United States Telephone Association this year.

USTA represents more than 1,100 local telephone companies, ranging in size from the seven regional Bell companies to companies serving as few as 30 homes.

USTA members roughly provide 99 percent of all the local telephone company provided lines in this United States.

Mr. Chairman, in April of 1986, our association came before this committee to testify against the proposed extension of the telephone excise tax as a revenue measure.

One year later, we return to testify not only against the proposed extension of the telephone excise tax, but also against proposals to extend and broaden the tax.

I would like to bring to this committee's attention a Washington Post/ABC News poll published July 2 that reported on the public's view of various proposed taxes.

The highest disapproval rating of all was the disapproval of any increase in taxes on telephone service. 87 percent of those Americans polled rejected them.

And as a matter of interest, only 74 percent opposed personal income tax increases. Opposition to all other taxes was far lower.

The USTA opposes the extension and increase of the telephone excise tax for several very important reasons that are detailed in my written testimony.

The telephone excise tax fails to meet any of the three criteria for a legitimate excise tax set forth by Assistant Secretary of the Treasury, Roger Mentz, last year.

Those criteria involved external social costs, the concept of users fees, and nondistortive consumption taxes.

Also, the telephone excise is regressive, impacting more severely on lower income rate payers and is the only tax on a basic service.

As you know, there is no tax on electricity, gas, or water.

The proposal to expand the tax by repealing exemptions is unjustified for the same reason that we oppose the imposition of the tax on our customers in the first place.

Broadening the tax makes it less likely the tax will be repealed, even though Congress has favored repeal for some time. An improper tax does not warrant new targets.

Moreover, each exemption was placed in the code for specific reasons that included concern about the application of the basic tax itself to specific groups or circumstances.

Clearly, there is little justification for continuing, expanding, or increasing the telephone excise tax. Congress has been trying to eliminate it since 1959, and it should do so now.

Further, the Joint Committee on Taxation has proposed a 10 percent tax on telephone equipment sales. This may not have the impact expected by the committee.

In an era when the distinctions between computers and communications equipment are becoming blurred, it would be difficult to distinguish which equipment should be subject to a communications equipment sales tax.

First of all, the same equipment can be purchased for communications and noncommunications purposes. Second, much of the equipment purchased today provides both taxable and nontaxable services simultaneously. Moreover, the imposition of a one-time 10 percent sales tax is not comparable to an ongoing three percent tax on communications services.

This tax would be difficult, if not impossible, to administer in a fashion that would ensure parity among today's untaxed bypassers and taxed local telephone customers.

The staff proposal recommending a higher rate of tax for radio-based telecommunications service is unwarranted. It represents a discrimination between various technological means of providing telecommunications services.

It would affect the technology choices and could discriminate against people in rural areas. Radio technology's future is extremely bright. It holds great potential for rural telephone customers.

And that is why the Federal Communications Commission has encouraged the use of mobile radio technology by local telephone companies in high cost areas.

To that end, a number of telephone companies are conducting trials of digital radio phone technology as a practical means of bringing telephone service to rural areas where installation of conventional cable is prohibitively expensive because of distance, difficult terrain, or low population density.

What may be erroneously perceived as a luxury item is actually the new hope for clear, affordable, state-of-the-art service for rural customers.

Finally, little revenue would be generated from the differential tax on radio-based service.

Mr. Chairman, I believe that our customers do not deserve to be singled out for a discriminatory tax on a basic service. The telephone excise tax should be permitted to expire at the end of this year as scheduled, and alternative taxes should be rejected. 87 percent of the Americans polled seemed to agree.

Thank you, Mr. Chairman, for allowing me to appear before you today.

The CHAIRMAN. Thank you very much, Mr. Miller. Mr. Edward O'Brien is the President of the Securities Industry Association in New York. Mr. O'Brien, we are pleased to have you with us.

[The prepared written statement of Mr. Miller follows:]

Written Statement
of
Bennet R. Miller
President of Tri-County Telephone Company
New Richmond, Indiana

on behalf of the
United States Telephone Association

Before the
Senate Finance Committee
United States Senate
July 15, 1987

Thank you Mr. Chairman, my name is Bennet R. Miller, and I am President of the Tri-County Telephone Company in New Richmond, Indiana, and Chairman of the United States Telephone Association. USTA represents more than 1100 local telephone companies ranging in size from the regional Bell companies' local telephone subsidiaries to companies serving less than thirty homes. USTA member companies provide roughly 99 percent of the local-telephone-company-provided lines in the United States.

I would like to state for the record that local telephone companies do pay taxes and have, in fact, relatively high effective tax rates.

Mr. Chairman, in July of 1986, I came before this Committee to testify against the proposed extension of the telephone excise tax as a revenue raising source.

One year later, I find myself back before this Committee to testify not only against the proposed extension of the telephone excise tax but also against a proposed increase in the telephone excise tax, and against various other adjustments that would act to expand and broaden the tax.

1. A RECENT POLL INDICATES CONSUMERS MOST STRONGLY OPPOSE TAXES ON TELEPHONE SERVICE

I worry greatly that some in Congress may incorrectly perceive that regulated local telephone companies and their customers are an easy source for general revenue raising, and that taxes imposed on local telephone customers go unnoticed. To correct this misperception I would like to bring to this Committee's attention a Washington Post-ABC News Poll published July 2 (see attached) that demonstrates that Americans disapprove of further taxation of telephone service to a greater degree than they disapprove of any other revenue-increase proposal. Eighty-seven percent of Americans polled--seven out of eight--disapproved of increased taxation of telephone use. This 87 percent disapproval is even greater than the 74 percent who disapproved of raising personal income taxes generally and it far outdistanced the disapproval ratings of all other proposed taxes. Customers of local telephone companies do not want to be singled out for discriminatory treatment.

2. THE EXTENSION AND INCREASE OF THE TELEPHONE EXCISE TAX IS INAPPROPRIATE

USTA opposes the extension and increase of the telephone excise tax for three very important reasons:

First, the telephone excise tax fails to meet any of the three criteria for a legitimate excise tax, as set forth by Assistant Secretary of the Treasury Roger Mentz in his testimony last year before the Senate Finance Committee.

Second, the telephone excise tax encourages uneconomic bypass of the public switched network, creating upward pressure on residential rates.

Third, the telephone excise tax is regressive and is especially burdensome because it penalizes telephone service, a basic service.

Treasury's Criteria Is Not Met.

In a statement before the Senate Finance Committee on April 21, 1986, Mr. J. Roger Mentz, the Assistant Secretary of the Treasury for Tax Policy, set forth the three circumstances under which the imposition of an excise tax may be justified:

The first criteria is "external social cost," when a tax represents a reimbursement to society for the external costs to society that are associated with the product or service taxed. There is no external social cost associated with telephone service.

The second criteria is the "user fee," an excise when the federal government charges a tax for providing a product or service. Obviously this is not the case with the telephone excise tax.

Finally, there are "nondistortive consumption taxes", a rationale that is applied to a service or product that is unresponsive to price changes. These taxes are intended solely to increase revenue. The telephone marketplace is extremely competitive and responsive to price changes. Price is very important to telephone customers in this environment.

Clearly, the telephone excise tax does not fit any of the criteria for a legitimate excise tax.

Uneconomic Bypass is Encouraged by the Tax

The major competitive problem with the telephone excise tax is that it encourages uneconomic bypass of the public switched network. While customers of regulated telephone companies are subject to the tax, those who directly bypass local networks are not. The Congress has discussed application of a tax on bypass facilities in the past and determined that it would be very difficult to administer and would require a different enforcement mechanism than is used for regulated industry. A "bypass" tax might result in an additional penalty on local telephone customers.

The Tax is Regressive

The telephone excise tax is particularly unfair to consumers in that the tax is regressive. It is imposed at a constant rate and thus falls more heavily on lower income persons, since they must pay a higher percentage of their income in taxes. Further, it is a tax that is imposed on a basic service, essential to most homes and businesses. Only telephone service, among the four basic household services (electricity, gas, water and telephone), is subject to federal excise tax.

In summary, there is little justification for continuing, expanding or increasing a tax that: (a) fails to meet criteria identified by the Department of the Treasury for a legitimate excise tax; (b) encourages uneconomic bypass; (c) is regressive; and (d) is unrelated to other excise taxes on luxury products and services, or on items where the government seeks to recover social costs of use. This tax, about which Congress has had a policy in favor of elimination since 1959, should not be extended.

3. THE REPEAL OF EXEMPTIONS FROM THE TELEPHONE EXCISE TAX EXEMPTIONS IS A MOVE IN THE WRONG DIRECTION BECAUSE IT ACTS TO PERPETUATES THE TAX

The Joint Committee on Taxation's revenue options include a proposal to repeal current exemptions from the telephone excise tax. Among communications services not subject to the tax are private communications services, news services, international and other organizations, servicemen in combat zones, items otherwise taxed, official calls of common carriers and communications companies, non-profit hospitals, state and local governments, and non-profit educational organizations. Also exempted are installation charges and certain coin-operated services.

Though administering these exemptions creates burdens for telephone companies, their repeal from the excise tax is based on one incorrect assumption - the excise tax itself would remain in place. We oppose repeal for the same reasons that we oppose the tax on our customers in the first place. An improper tax should not be expanded. The exemptions were enacted after long deliberations for reasons that include an underlying concern about the effect of the basic tax in certain situations or on certain classes of providers or users.

While there might be disagreement about the impact that the exemptions cause in the competitive positions of market participants, Congress has identified other concerns about the telephone excise tax that also apply to local telephone company activities. With respect to the exemption for private communications services, which was placed in the Code in 1965, the House Ways and Means Committee Report (H. Rpt. 89-433) noted:

> Under present law, a private communications system such as a private line or a private intercommunication system set up for a single subscriber (such as a PBX system or Centrex service) is taxed as a part of general telephone service if the telephones in this system have access to the local exchange system.
>
> This has presented problems under present law because of competition from untaxed private equipment performing similar services. The telephone companies presently are losing intrapremise business (and interpremise business within local areas) to those providing telephone and microwave equipment which can be purchased and operated by the users themselves. Installation of equipment in this manner is accompanied by a reduction in the service from the local telephone company. Businesses installing their own internal communications systems in this manner avoid the tax on the telephone company's charge for both equipment and

> services. With the ever-increasing number of varied services which modern science makes it possible for telephone companies to provide, the tax on private communication systems represents a severe competitive handicap to the expanded use of these new and varied services.

Technology and the competitive nature of the marketplace have changed dramatically since this exemption was enacted, making the importance of its goal--parity among providers of telecommunications services--more critical than ever.

Despite the policy and consumer objections to the imposition of the tax, the telephone excise tax is still considered as a source of revenue for the Treasury. The tax has continued in great part because consumer interest groups have not opposed it. The attached Washington Post/ABC News poll suggests that consumer reaction may not be so indifferent going forward.

4. TAXATION OF TELEPHONE EQUIPMENT SALES INVOLVES UNIQUE ISSUES.

The Joint Committee on Taxation's revenue options include "...a 10 percent excise tax... imposed on all telephone equipment (including fiber optic links) and communications satellites sold to persons for use in a manner not subject to the telephone excise tax." Though there may be merit in instituting public policy measures to identify and discourage uneconomic bypass of the public switched telephone network, a sales tax on telephone equipment is different in form and effect.

As with the excise, it would be extremely difficult to identify and adhere to a rigid definition of the boundary between equipment that is subject to the tax and equipment that is not subject to the tax. The problem of comparability is two-fold.

First, in an era when the distinctions between computers and communications equipment are becoming blurred, it would be difficult for both the Internal Revenue Service and the industry to determine which equipment should be subject to a communications equipment sales tax. The same equipment can be purchased for communications and non-communications purposes. In addition, much of the communications equipment purchased today is used to provide both "taxable" and "non-taxable" services simultaneously.

Second, the imposition of a one-time ten-percent sales tax has different impacts than the imposition of an ongoing tax. The result could be to expose telephone company customers to the possibility of double taxation in part because of the superior ability of telephone companies to identify tax liability. This would not ensure parity between untaxed bypassers and taxed local customers. It would make the disparity worse. The solution is to eliminate the tax, not substitute another that is difficult to administer tax.

5. UNEQUAL TAXATION OF RADIO-BASED SERVICES IS INAPPROPRIATE

The Joint Tax Committee staff proposal recommends a higher rate of tax for certain radio-based telephone usage. For many of the same reasons set out above, it is unjustified. It would discriminate among various technological means of providing telecommunications services, and could cause uneconomic choices among them.

Radio-based technology has a bright future and may offer an alternative in rural areas to wire transmission for basic telephone service from local telephone companies. The Federal Communications Commission has encouraged the use of radio technology in high-cost areas where a radio link is less expensive than providing service through traditional copper wire. To that end, a number of telephone companies are conducting trials of digital radio phone technology as a practical means of bringing telephone service to rural areas where installation of conventional facilities is costly because of distance, difficult terrain, or low population density. Radio-based local telephone company service for rural residential customers is less expensive. In other words, what may be perceived as a luxury item may be a new hope for clear, affordable, state-of-the-art service for rural customers of local telephone companies. The cost of new radio-based services compares favorably with alternative technologies, and these systems also can transmit data, an advantage for customers with computers. To single out this new service with a differential tax would chill its development. It would penalize local telephone ratepayers who can use radio more effectively in getting telephone service from local telephone companies. In addition, little revenue would be raised.

CONCLUSION

Mr. Chairman, a tax on the use of the telephone is not a good idea. As indicated by the *Washington Post*/ABC News Poll, the telephone excise tax is very unpopular with the American people. Telephone service is a basic service, not a luxury item.

The telephone excise tax fails to meet any of the Treasury's criteria for a legitimate excise tax, and the proposals to broaden the tax would touch competitors unequally and affect technological choice. Consideration of such taxes could not come at a worse time. Local telephone companies are struggling to maintain a reasonable bottom line to the local telephone bill in the face of increasing costs and intense challenges from unregulated competitors.

Confidence in Reagan on Deficit Declines

Poll Finds Greater Trust in Congressional Democrats to Handle Red-Ink Problem

WASHINGTON POST-ABC NEWS POLL

Q. At this point, who do you trust to do a better job in reducing the federal budget deficit—Reagan or the Democrats in Congress?

Reagan	40%
Democrats	50
Neither	7
Other/No opinion	3

Q. Who would you say is more to blame for the large deficit, Reagan or the Democrats?

Reagan	46
Democrats	41
Both equally	9
No opinion	4

Q. I am going to mention some things that have been proposed to help balance the federal budget, and for each, please tell me whether you approve or disapprove of that proposal:

	APPROVE	DISAPPROVE	NO OPINION
A. Raising taxes on gasoline	27%	73%	0%
B. Raising taxes on liquor, beer, cigarettes	75	25	0
C. Raising taxes for telephone use	13	87	0
D. Raising taxes on airline tickets	42	57	1
E. Raising taxes on business corporations	67	32	1
F. Raising taxes on higher-income people	71	28	1
G. Raising income taxes for everybody	25	74	1

Figures are from a Washington Post-ABC News telephone poll of 1,506 people June 25 to June 29.

THE WASHINGTON POST

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STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, NEW YORK, NY

Mr. O'BRIEN. Thank you, Mr. Chairman, and good morning. Good morning, gentlemen, and thank you for the opportunity to appear before you today.

This morning I would like to primarily focus on the proposed excise tax on securities transactions.

A securities transaction excise tax—sometimes known as a STET—would jeopardize the United States' position as the premier world financial nation.

It would strike at the investments and savings of millions of Americans of modest means. We believe it would skew investment decisions and would discourage capital formation.

The proposal would affect millions of investors because ownership of stocks in the United States is really very broad based today.

Individual investors in treasuries, municipal bonds, corporate bonds, time and savings deposits and money market funds would also bear the burden of the tax.

Wealthy investors who do not move their transactions abroad will pay a transaction tax, but so will the majority of America's 47 million individual shareholders whose income is under $40,000.

Millions more will be taxed indirectly through their pension plans and increased insurance premiums and State and local taxes.

Money has always been fungeable, but technology has escalated the internationalization of financial markets, particularly within the last few years.

Last year, for example, foreign purchases and sales of United States equities totalled $275 billion, and United States investors bought and sold over $100 billion of foreign stocks.

With the internationalization of securities markets and the sensitivity of investors to transaction costs, this proposal will force some transactions into foreign markets reducing any revenues derived from the tax.

Transactions have already been diverted by transaction taxes in some other nations, including West Germany and the United Kingdom.

Moreover, many foreign countries with transaction taxes do not tax capital gains on stock investments. Japan, Italy, The Netherlands, and Belgium do not tax capital gains at all, and West Germany exempts long-term gains.

The seemingly small one-half of one percent transaction tax would quadruple transaction costs for institutional investors and double costs for individuals.

Under the tax, tax considerations will become a major factor in investment decisions and, I might add, an impediment to market efficiency.

This is directly contrary to one of the principal goals of tax reform. The tax will also increase the cost of equity and debt financing for corporations, as well as for governments.

For individuals who realize gains, the tax comes on top of a 40 percent increase in capital gains rates. Those who sell at a loss would also be taxed since the tax applies to all sales.

Application of a transactions tax forces a choice between discriminating against capital formation or taxing people of very modest means.

If the tax applies only to securities, then other assets and savings vehicles are given an edge by the Government.

On the other hand, a neutral application would tax millions of Americans who have interest-bearing checking and savings accounts.

In short, a transaction tax raises more problems than revenue.

There are several other provisions in the options book in which the SIA has an interest. First, reimposing a foreign withholding tax on interest could lose more revenue and increased Treasury borrowing costs and higher interest deductions than it would generate in taxes.

Next, the proposal mandating further reductions of the dividend received deduction will increase triple taxation, twice at the corporate level and again to the individual; and it will cause corporations to rely even more heavily on borrowing than on raising equity.

We are in opposition to withholding on dividends and interest applied only to securities. SIA did not oppose withholding in 1982, nor did we seek its repeal.

Since that time, our industry has developed systems to achieve a very high compliance as mandated by the Congress—probably as much as 90 to 92 percent.

The current proposal discriminates against savings vehicles. It raises most of its revenue by accelerating payment from individuals who are already reporting their income and paying taxes on it. It is unnecessary and unfair.

These proposals are flawed as a proven revenue raiser. Historic experience demonstrates that reduction of capital gains taxes not only spurs investment in capital formation, but it also increases tax receipts.

Congress retained the capital gains differential for some investors in 1987 only. We suggest you consider restoring a differential for all investors.

Mr. CHAIRMAN, we have tried in the interest of time to select certain parts of the options report for our presentation today. SIA is continuing to review these options, and we look forward to working with the committee as it considers ways to increase revenue. Thank you very much.

The CHAIRMAN. Thank you very much, Mr. O'Brien.

Our next witness is Mr. Alger Chapman, who is the Chairman and Chief Executive Officer of the Chicago Board Options Exchange. Mr. Chapman, we are pleased to have you with us.

[The prepared written statement of Mr. O'Brien follows:]

STATEMENT OF THE
SECURITIES INDUSTRY ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 16, 1987

Mr. Chairman and members of the committee, I am Edward I. O'Brien and I appear here today as President of the Securities Industry Association. I appreciate the opportunity to participate in the committee's hearings on revenue increase options.

SIA represents over 500 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types--investment banks, brokers, dealers, and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on the investment decisions of corporations and investors.

The Securities Transaction Excise Tax

A securities transaction excise tax (STET) would jeopardize the U.S.'s position as the premier world financial nation, strike at the savings and investments of millions of Americans of modest means, skew investment decisions, and discourage capital formation.

Historical experience and economic analysis argue against the implementation of a STET.

International Competitiveness in Financial Services

The internationalization of financial markets has escalated in the 1980s. In 1980, foreign gross transactions (purchases and sales) in U.S. equities totaled $75.2 billion. This activity reached a staggering $275.3 billion in 1986.1/ The momentum continued through the first quarter of 1987, with foreign gross transactions reaching $113.0 billion. U.S. investors have reciprocated. In 1980, U.S. investors' gross transactions in foreign stocks totaled $17.9 billion. In 1986, U.S. investors' purchases and sales of foreign stocks grew to $101.3 billion. In the first quarter of this year, U.S. investors' gross activity in foreign stocks climbed to $40.2 billion.

It has been observed that London's "Big Bang" is the first cannon shot fired in the battle for supremacy in international financial markets. Following the U.K., Canada undertook a major deregulatory program in 1986 and France has recently

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1/ We estimate that foreign activity accounts for 10%-12% of public volume on the NYSE.

announced proposals aimed at making its market more competitive. Other nations have recently announced similar liberalization programs.

The "Big Bang", the "Little Bang", and the proposed "Le Petit Bang" have, in part, been prompted by recognition of the huge amounts of capital available for both domestic and overseas investment. Just as foreign brokers and banks have established branches and subsidiaries in the U.S., U.S. brokers have already taken, and will be taking further, advantage of deregulatory measures in foreign countries by establishing additional offices in these market centers. Spurred by modern technology, competition in the securities industry has intensified and expanded to include foreign markets as well as domestic ones, a development that would not have been possible a decade ago.

U.S. companies are increasingly listing on foreign exchanges. A securities transactions excise tax will provide added incentive for overseas listings. Over 400 U.S. companies are now listed on four of the world's major foreign exchanges. Likewise, foreign companies have sought access to U.S. investors. The success of U.S. overseas mutual funds, 29 in 1983 and 74 in 1986, as well as the recent spate of "country" funds, attests to the continuing trend toward global markets. Combined NYSE, AMEX, and OTC listings show 281 foreign company equity issues and the ADRs of another 109 companies at year-end 1986.

Money has always been fungible. Today's technology has served to emphasize the speed at which money can move from one center to another without regard to geographic borders. The imposition of a transaction tax will send investors, both foreign and domestic, "shopping" for markets which offer the lowest transaction costs. For example, there is currently no transaction tax in Canada and depositary receipts, including those of American companies, are not subject to the U.K. stamp duty tax.[2] Foreign investors, who made net purchases of an annual record-shattering $18.2 billion of U.S. equities in 1986 and a quarterly record-breaking $9.8 billion in the first quarter of 1987, would no doubt turn to more familiar markets if the cost of transactions increase in the U.S.

Some major foreign markets have a type of transaction tax. The diversion of trading to other markets caused by such a tax has been noted. For example, German bankers believe that the Boersenumsatzsteuer, the West German stock exchange tax on secondary market transactions in shares and bonds, has been the prime cause of the development of healthy secondary markets in West German stocks in foreign centers like London and Luxembourg.[3]

2/ Newly created depositary receipts will be subject to a one-time 1.55 U.K. stamp duty reserve tax, an expanded version of the stamp duty instituted in October 1986. As of June 1986, about 195 U.S. companies were listed on the London stock exchange.

3/ "German bankers urge tax repeal", Financial Times, 3/6/87.

The U.K.'s transaction tax, the stamp duty, is payable by the purchaser only. While the rate has varied over the years, in conjunction with the "Big Bang", this tax was reduced to 1/2%. It has been observed that there has been a substantial pick-up in turnover on the U.K. exchange attributable to the reduction of the tax as well as deregulation.[4/] For example, reported trades on the London stock exchange increased some 85% in the November 1986 - May 1987 period from the January - October 1986 period. (History: 2% (1957) to 1% (8/63) to 2% (5/74) to 1% (4/84) to 1/2% (10/86).) In comparison for the same period, reported trades on the NYSE increased 9%.

In 1985, the Bank of England published a research paper which explored the effects of the stamp duty on the U.K. stock exchange.[5/] The main reason for undertaking the study was the London market's lack of growth in turnover per stock. "[London's] Turnover as a percentage of market value was similar to that in New York in 1974, but over the past decade it has remained around the same level while the figure for the NYSE has almost trebled".

After concluding that the holding patterns of U.K. stocks (institutional versus retail) did not explain the lack of growth of turnover, the study examined transaction costs for the NYSE and Tokyo, NASDAQ and London exchanges and concluded: "Clearly, London is at a disadvantage compared with its major competitors." The results of the econometric simulations in the paper showed that the Stamp Duty had a significant dampening effect: halving of the rate of tax would increase the volume of transactions by 70% and share prices by 10%. As noted in the preceding page, London has experienced a 85% increase in reported trades which is supportive of this conclusion.

A securities transaction tax, in addition to the significant capital gains tax rate in the U.S. would put our domestic markets at a distinct competitive disadvantage. Many foreign countries with transactions taxes do not tax capital gains on portfolio stock investments.[6/] Among ten major foreign countries, Belgium, Italy, Japan and the Netherlands do not tax capital gains at all, and Germany does not tax long-term gains (holding period of six-months).

Compared with the five countries taxing long-term gains, the U.S. treatment of capital gains is among the harshest of the major industrialized countries. Canada, France, and Sweden tax long-term capital gains at rates ranging from 16% to 18%.

[4/] Turnover is defined as the volume of shares traded as a percentage of total shares listed on an exchange.

[5/] "The effects of stamp duty on equity transactions and prices on the U.K. Stock Exchange", Paper No. 25, Bank of England, October 1985.

[6/] Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock Investments in Seventeen Countries, Arthur Andersen & Co., April 1987.

Table I

Comparison of Individual Taxation of Capital Gains on Portfolio Stock Investment in Industrialised Countries

Country	Maximum Short-Term Cap. Gain Tax Rate	Maximum Long-Term Cap. Gain Tax Rate	Period to Qualify for Long-Term Gain Treatmt.	Maximum Annual Net Worth Tax Rate
Untied States 1987(A)	38.5%	28%	More than Six Months	None
Industrialized Countries				
Australia	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada(C)	17.51%	17.51%	None	None
France(D)	16%	16%	None	None
Germany(E)	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan	Exempt	Exempt	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden	45%	18%	Two Years	3%
United Kingdom(F)	30%	30%	None	None

Source: Arthur Andersen & Co.
Note: Based on exchange rates on March 31, 1987. State, provincial and local tax rates not included.

(A) As of January 1, 1988, the maximum short-term capital gains tax rate is 28%.

(B) The above maximum short- and long-term rate are comprised of 1.25% Medicare Levy and 49% Income Tax. Prior to July 1, 1987, the Medicare Levy will remain at 1.145% and the Income Tax will remain at 57.08% (aggregating 58.225%). Long-term capital gains qualify for special exemption and inflation indexing of the cost basis.

(C) Canadian residents are allowed an annual capital gains exemption of $22,998 (Canadian $30,000) subject to a cumulative exemption of up to $383,300 (Canadian $500,000) by 1990.

(D) Gains from proceeds of up to $45,288 (FF 272,000) are exempt from taxation in a given taxable year.

(E) The first $554 (DM 1,000) of short-term capital gains is exempt from tax.

(F) The first $10,096 (£6,300) of gain is exempt annually.

While Australia and the U.K. have higher statutory long-term capital gains tax rates than the U.S., substantial exemptions and indexing of the cost basis result in more favorable tax treatment of capital gains by these two countries than in the U.S.

Four of the industrialized countries reviewed exempt short-term capital gains from taxation. Australia and Germany have higher short-term capital gains rates than the U.S. However, as explained above, Germany exempts long-term capital gains and Australia has liberal provisions which favorably affect the overall taxation of capital gains.

Signs of globalization multiply on an almost daily basis. The mere fact that exchanges continue to look for international linkages, such as the Toronto/Amex link, suggests markets are no longer only domestic. Many countries are undertaking major deregulatory programs in efforts to ensure their position internationally in financial services. For example, Toyko has allowed six foreign firms to have seats on the stock exchange. France has recently announced its plan to internationalize the Paris stock exchange by opening its tightly controlled membership to foreigners.

As global competition intensifies in financial services, increasing transaction costs through taxation would jeopardize the U.S.'s international position.

The Fat Cats?

There is a misconception that only the wealthy own securities. At the end of 1986, households had $3.3 trillion or about 37% of their financial assets in securities -- Treasuries, municipal bonds, corporate bonds, etc.[7] Well over half, 56%, of the securities holdings of individuals is invested in corporate equities. The NYSE's profile of the average investor dispels the myth that only the wealthy have stock holdings. More than 47 million Americans own stock directly. The average shareowner is 44 years old, has a household income of $37,000, and a portfolio of $6,200. The typical new or first-time investor shares a similar profile and starts out with a portfolio of under $3,000.

Moreover, a transaction tax strikes regressively at the savings and investments of Americans of modest means. About $2.1 trillion, or 24%, of the financial assets of individuals are tied up in time and savings deposits and some $228.4 billion are invested in money market funds. So too, millions of Americans have retirement funds invested in securities -- company pension plans, 401(k)s, IRAs. All these savers would bear the tax -- directly or indirectly.

Many institutions, previously tax-exempt, would pay this tax on their securities transactions. Pension fund reserves of households total almost $2.0 trillion. The vast majority of these pension monies are invested in securities. For example, insurance companies managed some $827.9 billion of private pension funds at year-end 1986. Of this amount, 96% was invested in corporate equities and credit market instruments. Moreover, state and local governments hold $501.8 billion in retirement funds, with $180.3 billion invested in equities, $158 billion in mutual funds, and $135 billion in corporate bonds.

Costs

A tax of less than 1.0% on anything appears small on superficial examination. However, it erodes the returns to all savers and investors and translates to a substantial cost increment. For example, using a 0.5% rate and an average share price on the NYSE of about $41.90 at the end of May, a pension fund manager would be paying a tax of about 21¢ per share. Estimating that institutional commissions range from 5¢ to 7¢ per share, the transactions tax increases the cost of trading by 3 to 4 times. An increase of this magnitude will artificially dampen institutional trading and subsequently reduce the estimated revenue to be generated by this tax.

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[7] Flow of Funds individual sector defined as households, farm business and nonfarm noncorporate business.

For individual investors, who hold $1.9 trillion or about 63% of the total $3.0 trillion of equities outstanding, the cost of equity investment jumps with the imposition of the transaction tax. Assuming that the retail commission charge varies from 25¢ to 30¢ per share, the 20¢ transaction tax pushes costs up by 67% to 80%. On top of the 40% increase in long-term capital gains tax rates in 1987 and another 18% increase in 1988 for some investors, the average investor will think twice about equity investment.

In addition, the tax would appear to be levied twice on pass-through entities and their investors. For mutual funds, fund managers would be taxed at the fund level when they purchase and sell stocks, and the mutual fund investor might also be taxed when he purchases or sells shares of the mutual fund.

A Tax on the Winner and Loser

A tax which falls on the buyer and seller also falls on the winner and loser. It is clearly unfair to add injury to insult in the case of a capital loss. This is not a problem that can be remedied by the securities industry. While many of the operations of the industry are automated, there is no way of recording when a customer has a capital gain or loss.8/

Creating a Bias

The mountains of debt chalked up by consumers, corporations, and the government, reflect the tax code's bias favoring debt over equity. The U.S.'s low savings rate and level of capital formation have been pointed to as reasons for the erosion of U.S. competitiveness in international markets. A tax that applies only to securities investment is discriminatory. By lowering the return on securities, other assets such as real estate, art, and precious metals become that much more attractive, weighing the scales against capital formation. This bias could be eliminated by applying the tax to all assets and savings vehicles. However, neutrality would be achieved at the expense of millions more low and middle-income taxpayers who have interest-bearing passbook savings and checking accounts.

Artificial Considerations

Just as a securities transaction tax would skew the investment decision process, so too would imposing the tax on investments held for an arbitrarily determined period. By distorting economic behavior, both factors represent restraints on the free flow of capital. Market efficiency is based on the free movement and allocation of capital -- taxes and holding periods are detriments to market efficiency, keeping capital from flowing to those sectors where it is needed most and can obtain the highest return.

A Revenue-Raising Alternative

While historical experience and economic justification argue against the imposition of a transaction tax, there is a proven revenue-raiser with an outstanding track record.

8/ It was proposed several years ago that the industry report capital gain or loss information on the IRS 1099 form. However, when government realized that the industry did not track such information for most customers, gross proceeds reporting was the accepted solution.

TABLE II

Revenues and Realizations
($ Billions)

	SOI Series	Treasury Series		
	Sales of Capital Assets (net gain less loss)	Total Gains	Taxes Paid on Capital Gain Income	Effective Tax Rates
1977	$20.8	$ 45.3	$ 8.1	17.88%
1978	23.2	50.5	9.3	18.50
1979	28.4	73.4	11.7	15.89
1980	29.7	74.6	12.5	16.71
1981	30.8	80.9	12.7	15.61
1982	34.4	90.2	12.9	14.31
1983	48.9	122.0	18.8	15.41
1984	54.5	140.5	21.6[1]	15.41[1]
1985	66.7	NA	NA	NA

Source: Statistics of Income Bulletin and Office of the Secretary of the Treasury, Office of Tax Analysis.

[1] American Council on Capital Formation estimate.

Lower capital gains tax rates have proved effective and efficient at stimulating savings and investment -- and raising government revenues.

Capital gains tax revenues collected in 1979 and 1980 exceeded Treasury projections for those years before passage of the 1978 Revenue Act. Moreover, taxes paid on capital gains income continued to increase as the lower marginal rates of the Economic Recovery Act of 1981 were phased in. In 1983, a new plateau was reached, with taxes paid on gains spurting 46% to $18.8 billion from $12.9. Based on actual gains of $140.5 billion in 1984, the American Council of Capital Formation estimates a 1984 tax take of $21.6 billion, a 15% jump from the 1983 level. No public data for later years are available at this time.

No one factor accounts for the decision to realize gains in any given year. Market data and Treasury's estimated revenue take confirm that realizations were up considerably in the latter half of 1986, as individuals reacted to the sharp capital gains increase for 1987 contained in the Tax Reform Act. However, market data for 1987 also show that a heightened pace of individual gain-taking has continued this year, as upper-bracket taxpayers retain a differential for capital gains. We believe that the strong stock market has, thus far, offset tax considerations for investors. When the market subsides, our professional experience indicates that high capital gains tax rates will reduce the willingness of investors to realize gains and on Treasury revenues.

The historical experience of the revenue-raising potential of lower capital gains rates is being continually reinforced by academic research. A recent paper by Lawrence B. Lindsey shows that the Tax Reform Act of 1986 is extremely unlikely to produce any additional capital gains taxes and more likely to produce less capital gain revenue than under the old law.[9/] Lindsey's research points to a revenue maximizing capital gains rate range of between 9% to 21%.

Imposition of a Low-Rate of Withholding Tax on Interest Paid to Foreigners

The SIA strongly opposes the imposition of a low-rate of withholding on interest paid to foreigners because it would not raise meaningful revenues but would instead act as a protective tariff, preventing foreigners from buying U.S. Government and corporate interest-bearing securities and thereby leading to higher U.S. interest rates. Any incremental tax revenues generated by the withholding tax would be far outweighed by tax revenues lost as a result of increased interest deductions by U.S. private-sector borrowers and by increased costs of U.S. Treasury borrowing.

Less than three years ago in 1984, Congress eliminated the 30% withholding tax on portfolio interest in order to remove a barrier to foreign investment in U.S. debt securities.

Repeal of the withholding tax has been successful beyond all expectations:

- Net purchases by foreigners of U.S. corporate bonds increased from $903 million in 1983 to $43.5 billion in 1986;

- Net foreign purchases of Treasury Notes and Bonds rose from $3.7 billion in 1983 to $24.3 billion in 1986.

This very substantial inflow of funds has been an important factor in the post-1983 decline of U.S. interest rates and has helped to finance U.S. trade and budget deficits.

Reimposition of a withholding tax, even at a %5 rate, would severely curtail this trend, because it would represent a significant reduction (about 0.5%, at current interest rates) in the return to foreigners on U.S. debt securities. Foreigners would simply no longer buy significant amounts of securities subject to the withholding tax and would shift their funds to the vast supply of high-quality dollar-denominated securities issued by foreign companies and governments.

Since there would be very limited foreign investment in new U.S. debt securities (as in the period before 1984), only a negligible tax would be paid, and there would be no meaningful additional revenues to the Treasury from this source. Such a sudden shift in U.S. policy is also likely to engender skepticism on the part of foreign investors regarding the consistency of our policy toward investment by foreigners and is likely to create greater wariness than already exists about U.S. dollar denominated issues.

[9/] Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions, Lawrence B. Lindsey, April 1987.

Before the 1984 repeal, U.S. corporations could avoid withholding tax by issuing securities through foreign finance subsidiaries, generally located in the Netherlands Antilles. This would no longer be possible under the proposed withholding tax reinstatement as a result of the recent termination of the tax treaty with the Netherlands Antilles. Thus, U.S. corporations will be forced to absorb the tax if they wish access to foreign debt markets. This incremental expense would place them at a disadvantage compared to borrowers of all other industrialized countries, each of which permits its national borrowers to issue debt securities free of withholding tax. Similarly, the U.S. Treasury will have to pay a higher interest rate to reflect the tax on its securities in order to entice foreign investors. At best, the effect will be no net revenue increase to the Government. At worst, by raising U.S. interest rates generally, the withholding tax would magnify interest payments by the Treasury and increase the budget deficit.

Finally, reimposition of a withholding tax would directly contradict the consistent recent policy of the United States in favor of deregulation of international financial markets and would undermine U.S. efforts to encourage other industrial countries (particularly Japan) in the direction of further deregulation.

The Dividends Received Deduction

The SIA urges Congress not to adopt any proposal which eliminates or sharply reduces the corporate dividends received deduction. Such action would strengthen a regime of triple taxation. Dividends would be taxed twice at the corporate level and once at the individual level, reversing the long-standing policy of taxing corporate income only once at the corporate level. This is particularly inappropriate where the distributor is the corporate alter ego of the distributee.

Significant changes in the dividends received deduction will cause serious dislocation and disruption in the securities markets. The market value of securities held predominantly by corporations (e.g., adjustable rate preferred stocks and high yield common and preferred stocks) will decline causing significant loss to shareholders.

In addition, such a rule will impair the capital markets and restrict the ability of corporations to raise capital. Dividend rates on those securities most likely to be held by corporations and the cost of raising capital will increase. Corporations will become more highly leveraged (and therefore, more at risk) as the availability of the interest deduction increasingly causes corporations to borrow money rather than raising equity.

Market Discount Bond Proposal

The revenue options pamphlet proposed that, in an effort to increase accurate accrual of the market discount on bonds, brokers regularly report the amounts of such accruals to the IRS. This scheme is completely unworkable. There is presently no computer system which could track such accrual as the bonds pass from one investor to the next. More importantly, calculation of the accrual requires specific knowledge of the price the investor paid for the bond (and, therefore, the amount of the discount). A broker, unless he or she actually sold the bond to the investor, has no way of verifying such information. The amount of the discount, for reporting purposes, will depend solely on the word of the investor. Since this is the current scheme, a reporting requirement will effect no meaningful change in the tax system, but will substantially increase brokerage houses' administrative costs.

Withholding on Interest and Dividends

SIA opposes the proposal to impose withholding on income from stocks and bonds. In the past few years, Congress has enacted several laws to ensure a high level of reporting of this type of income and severe penalties for underreporting. The securities industry has developed, at considerable expense, operations and systems to implement these laws, which include gross proceeds reporting and the establishment of a 20% back-up withholding system.

These systems were put in place at a time when the then-most-current compliance data on voluntary reporting of dividend and interest income was over 97%. The increased reporting and penalty systems instituted in recent years coupled with a high degree of voluntary compliance lead us to believe that government efforts to strengthen taxpayer compliance would be best directed to those sectors of the economy where no reporting system has been established.

From the revenue estimate for dividend and interest withholding, it would appear that the major portion results from accelerating quarterly tax payments for some individuals. On the other hand, lower income taxpayers may be subject to overwithholding, a particular hardship in the case of retirees dependent on dividend and interest income.

There is no justification to penalize those individuals who choose to save through investing in stocks and bonds. As shown earlier in this statement, millions of Americans of modest means have investments in securities instruments. It is grossly unfair to single out these savers and investors for withholding, given a high level of voluntary compliance.

Other Items

The pamphlet released less than two weeks ago, "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means", includes numerous other proposals which will affect savings and investment. SIA continues to review these proposals, and regrets that it simply was not possible to formulate a response to all of them in such a short time. We will be pleased to work with this committee, and its members and staff as your consideration of revenue options continues.

SUMMARY

A securities transactions tax would be an ill-conceived one. In an era of intensifying competition for dominance in international markets, such a tax holds the potential to drive foreign investors as well as domestic ones, to other shores. In an era of recognition of the need to save and invest, such a tax strikes at the savings and investments of almost all Americans in one form or another.

SIA opposes further reduction of the dividend received deduction which mitigates triple taxation of corporate income and believes the proposal on market discount of bonds is incapable of implementation. We do remind the panel of the evidence that lowering capital gains taxes increases tax receipts.

STATEMENT OF ALGER CHAPMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHICAGO BOARD OPTIONS EXCHANGE, CHICAGO, IL, ACCOMPANIED BY J. GREGORY BALLENTINE, PRINCIPAL, PEAT MARWICK MAIN & CO.

Mr. **Chapman**. I would request that my written testimony be received for the record. It has previously been submitted.

The **Chairman**. That will be done.

Mr. **Chapman**. And I am accompanied today by J. Gregory Ballentine, a Principal with Peat Marwick Main & Co., who is sitting behind me.

I would just like to focus on one or two aspects of the securities transaction tax. I think Mr. O'Brien has covered the very broad base—the same ground I might otherwise cover—and I will address areas that deserve special emphasis.

The CBOE, which is the world's largest options exchange, opposes a STET for a number of reasons. Probably the most important reason is that the tax will be imposed on investors whether or not the transaction that is being taxed has resulted in a profit.

It can be a break-even transaction; it can be a loss transaction; it can be a profit transaction.

And those people on whom it will fall are a very broad group of people, and I put them in three general categories.

As you look at where investment has gone over the past 25 years, there has been a dramatic shift to the institutionalization of investing.

Thirty years ago when I came into the securities business, I would say 30 percent of an average day's volume, or maybe even less than that, was institutional volume in our securities markets.

And today, if you look at the markets, it is 80 percent of the volume or higher on an average day. It is conducted by institutions which represent pension funds and insurance companies' annuitants, retirement funds for various State and Federal employees.

And the character of the markets has changed dramatically. The participants have become much more sophisticated, those who are the intermediaries managing those funds.

And in the course of those years, our markets were the envy of the world then, and they have become increasingly the envy of the world.

This tremendous flow of funds into financial assets, into paper assets, has put us in the position where we have hundreds of billions of dollars that are every day being reviewed to determine whether risk should be adjusted and managed.

Whether the risk profile of a pension fund or retirement fund meets the actuarial assumptions or exceeds it, and to adjust risk in favor of more return, is going on in our marketplaces every day.

Those markets are now still the envy of the world. They are deep. They are liquid. They facilitate capital raising. They provide a vehicle for risk shifting and tailor the needs of risk profiles of investors' portfolios, institutional and individual.

As Mr. O'Brien said, our markets are going through a period of internationalization and globalization; and we are in the midst of it at the CBOE, the other Chicago markets, the New York markets; and the dominance of the U.S. markets is seriously under attack.

I see our markets going through the same kind of stress period that many of our businesses have in this country, losing market shares to overseas. Foreign governments very often support their marketplaces in achieving their international market position.

The U.K. has recently changed the London Stock Exchange dramatically. It has been done by the members but with the full support and urging of the Bank of England and the Treasury They have now become an international marketplace; every day there is a liquid market in the top 70 or 80 securities traded on the New York Stock Exchange.

That number is growing dramatically.

In Japan, the government—as we now know—supports whatever business policies are established; and the Japanese are currently looking at their markets with their tremendous surplus capital position, putting in motion, I think, the programs to try and become the global 24-hour marketplace for world financial assets.

When I left the Exchange yesterday afternoon, I noticed that in our visitors' gallery, we had 30 Japanese securities professionals who were coming in to try and understand how our marketplace works.

And I asked somebody to give me a list of our visitors during the month of July, and there were 130 Japanese securities professionals that will be in our Exchange in Chicago during the month of July.

They have all come to learn how we do it, how we run our markets.

I think we have a serious concern that, with the imposition of this kind of a tax, we will handicap ourselves in that struggle to maintain the dominance of our capital markets internationally.

Thank you very much for the time to speak to the committee on these subjects.

The CHAIRMAN. Thank you very much, Mr. Chapman.

[The prepared written statement of Mr. Chapman follows:]

STATEMENT OF ALGER B. CHAPMAN
ON BEHALF OF THE CHICAGO BOARD OPTIONS EXCHANGE
BEFORE THE SENATE COMMITTEE ON FINANCE
July 16, 1987

I. Introduction

Mr. Chairman and members of the Committee, I am Alger B. Chapman, Chairman and C.E.O. of the Chicago Board Options Exchange (CBOE), the world's largest options exchange. I am accompanied by J. Gregory Ballentine, a principal with Peat Marwick Main & Co.

The CBOE appreciates this opportunity to express its views concerning a proposed securities transfer excise tax (STET). CBOE opposes such a tax. A STET, while nominally an excise tax, will lower the income of investors and traders in securities. Thus, the tax has an effect similar to an income tax, but completely fails the tax policy criteria applied in recent tax reform legislation. Specifically, a STET:

(i) is not based on ability to pay and will affect adversely the investments and retirement plans of middle and lower income Americans; and

(ii) is not neutral.

Further, a STET will:

(i) reduce liquidity in securities markets and reduce the ability of participants in options and futures markets to shift risk from those who do not wish to bear risk to those willing to do so; and

(ii) encourage an outflow of transactions to foreign securities markets while adding to the tax burden on investment in the U.S., thereby tending to raise the cost of capital.

II. The STET is Inconsistent with the Principles Used in the Tax Reform Act of 1986

While nominally an excise tax, the STET is not a true excise tax. The transfer tax is imposed on transfers of income producing or risk shifting securities and ultimately will lower the portfolio income for all types of investors. Thus, the tax has an effect similar to an income tax. The tax should be evaluated using the same criteria -- ability to pay and tax neutrality -- that Congress recently applied during the debate over tax reform.

II. (a) Ability to Pay. There is a misconception that securities are held and traded only by wealthy individuals and that, as a result, a STET is a progressive tax that is consistent with the ability to pay criteria. While a STET is probably progressive in a very general sense, it is not based on ability to pay. The tax will fall on low income persons as well as on wealthy individuals. The tax will lower net income earned by pension portfolios and, thereby, will lower the retirement income of many middle income employees who ultimately own the pension assets. A similar effect will arise from the tax burden on transactions undertaken by insurance companies. Policyholders at all income levels will bear the burden of reduced net income on insurance reserves.

In addition to this indirect burden imposed on lower and middle income persons, other middle income persons will be affected more directly. The tax will fall on many elderly persons of modest means who periodically sell securities to assist in financing their retirement years. Further, many middle income investors who own shares in mutual funds will be affected by the STET because the tax on the funds's transactions will lower the return on the fund, causing holders of mutual funds to bear the burden of a STET.

Because the STET is based on the volume of transactions undertaken, those bearing the greatest tax burden will be those who make the most transactions, not necessarily those with the highest income. A middle income person whose pension funds or whose IRA mutual fund makes several trades will bear a higher tax burden than a high-income person who makes few trades.

In addition, any given transaction is subject to the same transfer tax whether it yields income or a loss. As a result, for a given sales price, the transfer tax expressed as a tax rate on income is *inversely* related to the income earned on the transaction. The table below shows three hypothetical transactions all involving the sale of a security for a total price (*i.e.*, inclusive of the total STET) of $100. The basis of the security varies in the example from $50 to $99, thus the realized gain on the transaction varies from $50 to $1. The fifth column shows the STET expressed as an effective tax rate on the realized nominal capital gains. Clearly the tax has a perverse effect: the smaller the gain, which means the lower the income from the transaction, the higher the tax rate.

Sales Price Inclusive of STET	Basis	Gain	Total STET	STET Expressed As An Effective Capital Gains Tax Rate
$100	$50	$50	$1	2%
100	90	10	1	10%
100	99	1	1	100%

II. (b) Tax Neutrality. Ideally, business and investment decisions should be based on market considerations undistorted by taxes. A STET, however, will distort business and investment decisions.

The clearest distortion of the STET is the lock-in effect. Portfolio holders will tend to be locked in to their current portfolio even when market information makes it desirable for them to shift their portfolio.

The lock-in effect has a lock-out counterpart particularly relevant to options and futures markets and to risk shifting. An investor or portfolio manager may become concerned that a particular stock they own has a risk of falling sharply in price. Absent the securities transfer tax, that investor might purchase an option to sell -- a put option -- to hedge against such a price decline. The transfer tax, by effectively raising the cost of such a contract, may prevent pension fund managers from taking prudent actions to protect portfolio values.

Lock-in and lock-out effects are not the only distortions caused by the tax. If the tax is not applied to all securities -- a difficult term to define in our modern financial markets -- it will bias decisions in favor of untaxed securities. For example, if equity securities are subject to tax, but debt instruments are not, the tax will add to the existing bias in favor of corporate debt issues.

Even if the tax is applied to both debt and equity securities, it will bias decisionmaking. Firms will be induced to avoid short-term debt instruments that have a lower interest rate, but may need to be rolled over periodically, incurring a STET each time. The tax will also affect savers' decisions. They will tend to invest less in corporate bonds and other debt securities and instead place their funds in bank deposits.

Clearly the STET is not neutral. It will bias investment decisions, causing investors and portfolio managers to be less flexible in adjusting to new market information. This will cause portfolios to be more risky and less valuable than they would be if investors responded to market developments and signals undistorted by tax considerations.

II. (c) Congressional Action Revising the Taxation of Income From Securities and the Income of Security Dealers. Congress has spent several years, culminating in the Tax Reform Act of 1986, revising the tax system. Tax reform resulted in dramatic changes in the taxation of the income from securities, including, in particular, the decision to tax all nominal capital gains as ordinary income. As a result, securities holders are fully taxed on their realized nominal capital gains.

Over a period of several years, the securities and options industries have worked with Congress to devise a system of taxing traders and market makers in options and futures contracts. The mark to market system first enacted in 1981 now applies to all professional futures and options traders.

When these requirements were adopted, 60% of the gains from marking to market were taxed as long-term gains; the remaining 40% were taxed as ordinary income. With the recent elimination of the long-term gain exclusion, all income resulting from marking to market is now taxed at the same rates as ordinary income.

These changes in the tax treatment of investors and traders in securities have been the result of extended analysis that sought to apply objectively the standards of ability to pay and tax neutrality. The securities transfer tax clearly violates the very standards Congress used in the recent dramatic tax changes. In effect, the STET will raise the tax rate on capital income without explicitly increasing the rates enacted in 1986.

III. A Securities Transfer Excise Tax Will Limit the Economic Benefit of Securities Markets

A securities transfer excise tax will:

(i) reduce investors' liquidity and increase their risk;

(ii) likely increase the volatility of securities prices; and

(iii) reduce the U.S. role in world financial markets and reduce U.S. investments.

III. (a) The Effect on Domestic Securities Markets.

U.S. securities markets are central to the capital raising mechanism of our modern economy. Direct securities markets allow investors to invest in major corporations while maintaining their liquidity. Without such markets, an individual who had invested in say, G.M., but wished to shift to an investment in IBM, would have to seek out two other individuals, one was willing to sell IBM stock, and another who wished to invest in G.M. The securities markets and the many traders in those markets make such an investment switch much easier and, consequently, cause securities investments to be highly liquid. Increased liquidity makes investments less risky and thereby encourages investment.

The role and importance of options and futures markets may be less well understood than that of direct securities markets. Futures and options are contracts that give the holder the right (option) or the obligation (futures) to buy or sell a product or security at a specified price within a specified time. These contracts allow individuals who do not wish to bear risk with regard to future prices to shift that risk to someone else who is willing to do so. For example, a business that purchases a precious metal to make its product might shift the risk of an increase in the price of that metal by buying an option to purchase the metal at a fixed price.

In 1973, the CBOE began trading standardized options on equity securities. These are options to buy or sell a security (*e.g.*, stock in a major corporation) at a given price. Today such options, along with options and futures contracts for U.S. Treasury bonds, notes, and bills, and options on indexes of equity securities, are also traded on four other exchanges.

The trading of securities options and index options allows individual investors and portfolio managers -- managers for pension and insurance funds, for example -- to manage market risk, interest rate risk, and other risks. For example, a pension portfolio manager can limit the risk that the price of a particular security will fall by buying an option to sell that security at a fixed price or the manager can hedge against a general decline in the stock market by buying a put option or selling a call option on a broad index of stocks. Such strategies are a central part of prudent pension fund management.

These options and futures markets all allow individuals -- investors, exporters, businessmen, etc. -- who wish to avoid risk to do so. These markets do not create risk and, of course, they do not cause the underlying risk to disappear. The markets shift risk to speculators who are more willing or able to bear it.

Recently the Board of Governors of the Federal Reserve System (the Fed), the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC), studied the effects on the economy of trading in futures and options contracts.[1/] That study concluded, among other things, the following:

> "One of the important economic factors provided by the trading of speculators is the enhancement of the liquidity of the futures and options markets in which they trade. By increasing the volume of bids and offers in the market, speculators make it easier for those wishing to hedge [i.e., to avoid risk by shifting it to speculators] to establish and later liquidate such positions quickly and on competitive terms. And ... trading by speculators and other participants in futures and options markets also tends to add to the liquidity of underlying cash [*e.g.*, stock and bond] markets." (p. II-24)

The STET will reduce the economic benefits of direct securities markets and of derivative futures and options markets by decreasing trading volume, reducing liquidity, and causing investors to

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[1/] "A Study of the Effects on the Economy of Trading in Futures Options". December 1984.

tend to be locked into their current portfolio. It is difficult to quantify the effect on trading volume precisely. However, the Congressional Research Service has estimated that the securities transfer tax would cause about a 12.7 percent decline in trading volume.

The most dramatic effect of the tax will be on those speculators, specialists, and market makers that engage in numerous short-term trades. These are the traders that provide the liquidity that is central to the efficient functioning of the securities market. The total effect of a STET on a market maker can easily exceed the income tax liability on the market maker trades. Consider a hypothetical trader that throughout the year has sales equal to three times the trader's portfolio, with a total pre-STET gain on trading of 12%. The total STET is 3%, leaving a net gain of 9% which is subject to income tax.[2/] The income tax on this 9% gain, assuming the trader is in the 28% income tax bracket, is effectively 2.5% (*i.e.*, 28% of 9% is 2.5%). Thus, the transfer tax burden is well above the income tax liability for this hypothetical trader.

Clearly, the 1% rate can be very misleading. The tax is imposed on the full price of a sale, whether or not the sale generates any income, and even sales that generate a loss will be

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[2/] This assumes a 1% transfer tax, half of which is collected from the seller and half from the buyer. The convention of collecting part of the tax from the buyer and part from the seller does not alter the fact that the tax is a 1% wedge between the total price paid by the buyer and the amount received by the seller. Thus, a 1% STET is incurred for each sale, and since in the example sales equal three times the trader's portfolio, the total STET is 3% of the value of the portfolio.

taxed. Indeed, as demonstrated above, the effective rate of tax is negatively related to the income on a transaction. Since market makers cannot stay in business without making a profit and since a STET will be incurred on every trade they make, they will have to charge more for the trades they make. This will reduce the liquidity of the market. In recognizing that this tax is likely to reduce sharply the number of short-term trades, it is important to keep in mind the value of short-term trading. It is the almost continuous short-term trading of market makers that ensures the liquidity of the market. The investor that does not make frequent trades nonetheless values holding liquid assets. An illiquid or "thin" market -- one with few potential buyers and sellers -- is more apt to have volatile prices and is more risky. Short term traders fill out a thin market, providing greater price stability and reducing overall risk to an investor in the market.

The risk reduction that arises from a large volume of short-term trades is distinct from the risk shifting of options and futures contracts. As the Fed, CFTC, and SEC study indicated, a large volume of trading in the options and futures markets provides investors with the assurance that they can close out or take positions at competitive prices. If few trades take place, any investor must recognize the risk that, when he or she wishes to sell a security, some other investors may also sell and potential buyers will be swamped, leading to a sharp fall in price. Market makers, who are willing to make a large volume of short-term trades, diminish this risk.

III. (b) International Securities Markets. Not only will a STET lead directly to reduced trading and reduced liquidity, but it will also cause a shift of some transactions and some securities issues to foreign exchanges. While it is true that the United Kingdom, Japan, and West Germany have transfer taxes -- generally at rates less than 1% -- presumably those taxes have encouraged the development of U.S. securities markets and, thereby, the role of the U.S. as a world leader in finance.[3] Imposing a STET in the U.S. will tend to reverse these benefits.

It should also be kept in mind that in those countries where a securities transfer tax is in effect, there are other tax rules that are relatively favorable compared to the U.S. rules. Nominal capital gains are fully taxed in the U.S., whereas in the United Kingdom, Germany, and Japan they are either untaxed or taxed at a rate less than that on ordinary income.

With the growth in the volume of international trade, the huge U.S. trade deficit, and the transformation of the U.S. from a creditor to a debtor nation, improving U.S. competitiveness has become increasingly important. While the tax structure probably is not the major determinant of our overall competitiveness, taxes can have an impact for better or worse, and the effect of a STET is clearly for the worse.

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[3] German bankers have indicated that the West German stock exchange tax on secondary market securities transactions has caused the development of healthy secondary markets in West German stocks in foreign centers. "German Bankers Urge Tax Repeal," Financial Times, 3/6/87. This was noted in the testimony of Edward I. O'Brien before the Committee on Ways and Means of the House of Representatives, July 8, 1987, p. 2.

III. (c) The Effect of the Tax on Investment. Another way in which the STET will harm the U.S. economy and our ability to compete internationally is through its effect on investment. New corporate investment is financed by issuance of new securities or by increasing the value of existing securities through retained earnings. The tax will have an immediate effect on investment financed by the issuance of new securities since one percent of the value of the security issuance is taken in tax. Further, the expected return on the security is reduced because investors must take into account the probability that they will sell the security at some point in the future, triggering an additional transfer tax.

Investment financed by retained earnings is also affected by the transfer tax because the increase in stock value due to the retained earnings increases the future transfer tax liability.

To a certain extent, the effect of the transfer tax on the cost of capital and on the returns to investors is similar to the effect of an increase in the capital gains tax rate. The effect of the transfer tax is broader, however, since it is imposed on the initial issuance of a security, not just later transfers and since pension plans that are exempt from income taxes would be affected by the transfer tax. Further, the tax would be imposed on a transfer, whether or not income is realized on the transfer.

In the short-run, the transfer tax will reduce the net return to savers in the U.S. economy and, thereby, exacerbate the tax bias in favor of consumption. In the long-run, this bias in favor of consumption will persist and the tax will raise the cost of capital and discourage investment. While the size of the effect of increases in effective tax rates or in the cost of capital on U.S. investment is controversial, it is clear that there is a negative effect. Undoubtedly a securities transfer tax will tend to reduce investment.

IV. Conclusion

The securities transfer excise tax is not based on ability to pay and is not neutral. It will decrease liquidity in securities markets, increase the riskiness of investments in securities, and potentially lead to greater volatility in prices. It will also harm the role of the U.S. as a leader in world financial markets. Congress should reaffirm its commitment to basic tax principles and reject the securities transfer excise tax.

The Chairman. There is no question that your Stock Exchange and the Options Service serve a very valuable purpose in raising capital in this country.

Let me ask you and Mr. O'Brien: You are talking about the average shareowner not being a fatcat these days, and I think that is true. And as I understood your numbers, the average shareowner has a portfolio of about $6,200.

So, if you had an Exchange tax at .15 percent on that portfolio on a year's transactions, if it turned over once, which would seem to me quite a turnover for the average shareholder, that would be $9.30.

It would also seem to me that that transaction tax would most affect the high volume trader, more the speculator who wants to get in and out of the market fast.

Would you comment on that?

Mr. O'BRIEN. Certainly, the $9.30 tax in and of itself would not seem to be a deterrent, Mr. Chairman; and it is also true that, with a high volume transaction trader, for example—maybe a pension fund, maybe an individual—that it would have on the face of it, if the tax were paid, a more pervasive effect.

The problem, I think, is that today the ability to do something about the tax is within the power of people—he internationalization of the markets coupled with the technology.

When I came into the business about 32 years ago and I was responsible for our offices throughout the world, you would be in London and nothing was happening; and we were waiting for the American markets to open.

Today, that is not the case. The markets in London, in Tokyo, and the U.S. are in competition with one another.

So, the answer is that people will have the opportunity, the ability, and the means to do something to move the transactions to another market throughout the world.

We also have seen a tremendous increase in listing of American shares in other places.

The CHAIRMAN. There is no question about that; and there is no question, Mr. Chapman, about the kind of competition you are talking about and the intensity of that competition and the growth of that competition.

Mr. O'BRIEN. Right.

The CHAIRMAN. But as you talk about the flight of capital I also understand that the United Kingdom, that West Germany, that Japan have such a transfer tax and that it is as much as one-half of one percent and higher.

We are talking about a .15 percent transaction tax here. Why would there be such an exodus of capital where their tax would be actually higher than it is here?

Mr. O'BRIEN. One thing that does occur to me, Mr. Chairman, is that in the United Kingdom, in anticipation of the deregulation of their markets, they have actually reduced their tax, rather than keep it at the same level.

The CHAIRMAN. What have they reduced it to, Mr. O'Brien?

Mr. O'BRIEN. I have it in my written statement. I will be glad to get it for you.

The CHAIRMAN. But you do have it in your statement?

Mr. O'Brien. Yes, I do, Mr. Chairman.

The Chairman. Yes.

Mr. O'Brien. And by the same token, there is some evidence that in Germany the existence of a tax has also had an effect to drive some business away from Germany.

Now, I think it is not something which you can quantify as a cause-and-effect relationship and say that because it is a tiny tax, it is there.

The Chairman. I am told that it is one-half of one percent in West Germany, but I am not sure of that number either; so we will get it for the record.

Mr. Osterman, I was interested in your statement about it being a nightmare collecting an excise tax on jewelry, and I was also looking at what the Joint Tax Committee had stated insofar as classifying something as a luxury.

They characterize jewelry and similar items with purchase prices of over $100 as luxury items. Now, do you agree with that characterization of jewelry as a luxury?

Mr. Osterman. Absolutely not. First, jewelry does fulfill an emotional need for a consumer, and the emotional well-being—the mental well-being—of a consumer is every bit as important as their physical well-being.

The Chairman. Then tell me, please, because my time is limited, why it is such a nightmare to collect it. If you are collecting a sales tax and then you have an excise tax, why is it so much more difficult?

Mr. Osterman. All right. It is simply an additional tax which the jeweler has to deal with. There is an enormous amount of paperwork to keep track of.

You are going to have different kinds of sales. Let's take a pair of earrings. What would happen: In order to avoid the tax, the person would sell one-half of the earring one day and the other half of the earring the following day.

In the selling of a diamond, you could sell the diamond one day and the mounting the next day.

The Chairman. I have seen some of these folks wearing one earring, so——

[Laughter.]

Mr. Osterman. We enjoy selling to those customers as well.

The Chairman. I see my time has expired. Senator Packwood?

Senator Packwood. Mr. Donohue, you are opposed to higher excise taxes. You have a whole variety of reasons, but your first reason is that they are regressive and that most of the excise taxes get passed along.

Do I state it correctly?

Mr. Donohue. Yes, sir, that is true. Eventually, they are passed along. I do believe there is an effect on particularly the smaller companies in the process, eventually getting to the consumer.

Senator Packwood. What taxes do businesses not pass along as readily?

Mr. Donohue. Well, Senator, any business that eventually doesn't pass on its taxes takes them in their profit base; and I think in a competitive environment, it has a very difficult time in their own survival.

But there are taxes that, for example, affect their end of the year profits. They don't get passed along many times until the recalculation of the next pricing arrangement.

For example, if we sat down now and owned a company and figured out what we owed at the end of the year—particularly at the end of the year adjustments—we might have to pay inventory taxes, taxes that deal with profits-offshore profits—and so on. And those usually are not passed along until a much longer period of time.

They have to be built into the next pricing arrangement.

Of course, in some businesses, prices change very dramatically in a dynamic form. In other businesses, in food for example, the margins are very small-although they don't have excise taxes on them--and you are very careful in that competitive environment before you start increasing your prices.

I think that if you go to a company now, the kinds of people that folks want to pay and are looking for are folks that are cash management experts and are people who are pricing experts because we have gotten so competitive in the last few years that the margins and the elasticity have gotten very tight; and so, the mix is changing.

The reason that the Congress and some people like excise taxes is that they are easy to collect. They are easy to hide, and they are easy to justify.

And I think for businesses they are easy, in many ways, to handle; but they certainly affect their consumers in a regressive way and many people have to hold onto them a long time before they can pass them on.

Senator PACKWOOD. Let me see if I can shorten your statement. Excise taxes are likely to be passed on sooner than a corporate income tax is?

Mr. DONOHUE. I think with the exception of very competitive industries and with the exception of—my answer is yes. And I think that there are exceptions, however, and the reason is that you can say I have just added this much to a pack or a gallon of where, when you just sit down and try to figure out what we did in tax reform, the accountants are going to have one great year trying to figure out who owns what in 1988 and 1989.

Senator PACKWOOD. Now, looking again at all of your reasons, they are not reasons to oppose excise taxes based on what they do to business. Your reasons focus on negative effects on consumers or States or the like. From the standpoint of the businesses—your trucking companies—and the others in the association, why wouldn't you prefer, from a business standpoint, excise taxes to an increase in corporate income tax rates?

Mr. DONOHUE. First of all, in our business, sir, there are many people not making a profit; and if they are making a profit, it is very small.

And that has been true in many of the businesses where profits have begun to shrink.

It is very clear that our argument on regressivity and regionalization and so on is based on the arguments that we can gather up to protect our businesses.

We are not hiding behind any great national good, as we make these arguments. What we don't want to do is we don't want to pay any more taxes in these businesses, and we don't want to—you know, I will be straight—we don't want to change the mix—the competitive mix—or the use of our products.

Each of the members of our coalition has a different situation. We bring an argument that we think makes a case for our position.

There are other arguments about wellness and health and all of those kinds of cases, and they have to be heard; but our situation is clear. We think that those who will pay these taxes are least able to do so. We think it will affect our business as we hold the tax in a competitive environment; and we think it will hurt the people most on the margin.

In the last analysis, all of the taxes under discussion will be paid by the consumers. People will be hurt in the process.

Senator PACKWOOD. And you would just as soon not make any recommendations as to what form of taxes we should levy if we have to meet the reconciliation instructions given the tax-writing committees in the FY 1988 budget resolution?

Mr. DONOHUE. No, except that I would make two personal observations. Number one, I feel as a representative of this group and personally, that if we are going to fix the deficit, we ought not do that in a segmented way.

Senator PACKWOOD. Could you explain what "segmented way" means?

Mr. DONOHUE. In a segmented way where we say to these consumers: You are going to pay for our deficit. We all ought to pay for it.

Second, I believe that when you get down to broad based taxes—and I could name five or six that have been named here today—that we get a little fairer about it. You know, you and I make a lot more money than the people who use most of these products and are going to pay a little more reasonable share of it.

Somebody said to me today: Tom, if you are successful in your feelings on the excise tax, you are going to upset our own personal situation.

But I can make a very clear argument for you that we would be better off paying more at the income tax pump or paying more in a broad-based tax than we would be placing it on a small group of consumers.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman. I want to point out, Mr. Chairman, that Mr. Osterman and Mr. Runci are here because they have been through a situation, namely, they had imposed on them the so-called "luxury tax" starting in the 1940s, which was to be a temporary wartime tax and continued up into the 1960s, as Mr. Osterman pointed out.

So, they are not just here crying wolf; they have been through this situation. And I want to point out that the reason I am so concerned about even the suggestion of a tax on jewelry is that in my State the jewelry industry represents a very substantial portion of our manufacturing employment.

We have 25,000 individuals in the jewelry industry directly in my State, and jewelry includes writing instruments as well; and several thousand more involved in collateral industries, such as boxmaking and electroplating and so forth.

So, this is a very serious proposition. And to suggest that a piece of jewelry costing over $100 should be taxed as a luxury and that a $500,000 second home should not be is, to me, preposterous.

There is no suggestion that jewelery is deleterious to one's health as the other matters we discussed with the prior panel. As a matter of fact, Mr. Osterman makes a very convincing argument that a little bit of jewelry is beneficial to one's mental health. [Laughter.]

He spoke very forcefully on that subject.

I would just like to briefly mention, Mr. Chairman, a profile—if I could—on the jewelry workers in our State. Nothing absolutely covers everybody, but the profile I think would show an individual who quite possibly is an immigrant.

This is their first job in the United States on the way up through the economic ladder. The skills they have are not transferrable readily.

They have no skills in many instances, and the jobs are not high paying. As a matter of fact, the jewelry industry is one of the reasons that our manufacturing wages are relatively low in our State because they are in a tremendously competitive position, as you know from statements I have made here previously.

So, therefore, I would like to see any suggestion of a tax on jewelry scotched right at the beginning. I want to say also—and it would surprise no one—that I would very vigorously resist such a tax because I think it would be so unfair.

There is also in the House some suggestion of a tax on boats as a luxury and that pains me just as grievously. [Laughter.]

Because the boat industry in our State, as you know, is some 2,000 more workers. As I have pointed out previously, we produce more sailboat hulls than any State in the nation; and they are fiberglass usually.

Indeed, the profile would show that they are immigrant workers, principally from the Azore Islands, that have come to our State.

So, this type of so-called luxury tax that is occasionally booted about is a bad idea from the very beginning; and I would resist it extremely vigorously and that would be an understatement. Thank you, Mr. Chairman.

The CHAIRMAN. Let the word go forth. All right. [Laughter.]

That completes your statement?

Senator CHAFEE. Yes, thank you.

The CHAIRMAN. Senator Daschle?

Senator DASCHLE. Thank you, Mr. Chairman. I was going to put a mild plug in for my jewelry industry, but nothing I could say could possibly compare to what has just been said.

So, I sympathize to a large extent with some of the comments made by Senator Chafee.

I would be interested in some comments from Mr. Donohue about the differences you perceive in excise taxes and consumption taxes in terms of progressivity.

Mr. **Donohue**. Obviously, any tax that is not progressive in its absolute structure is regressive; and let me give you an example, if I might.

If we had a consumption tax on some very simple product—basic clothes, for example—and I pay it. Even if I buy a product that is twice the expense of one that you buy, it is going to be less of a burden on my income than it is on somebody who is buying an essential item and paying it with a much lower income.

The whole question of excise taxes is not that I pay more excise taxes than you do on a gallon of gas; it is the fact that the regressive effect on you, as opposed to me, is significant.

I mean, a carpenter who works in your State and drives—because of the vast mileage—37 miles or 55 miles to his job and back again has a much different problem in an excise tax on fuel—or on some of the other products that we mentioned today—than I do even if I drive the same amount of miles.

I mean, quite frankly, I don't care what the excise tax on fuel is from a personal perspective. It is not going to change the elasticity on what I buy. It is not going to change my standard of living. It is not going to change my household ability to carry on the affairs of my family.

The argument that we present for our own personal benefit as well as for your consideration is that, when you put across-the-board excise taxes, those least able to pay carry the greatest burden.

Senator **Daschle**. You still didn't answer my question. Could you briefly summarize how you see the difference between a consumption tax, value added tax, alternative minimum tax, and an excise tax with regard to fairness and some of the criteria that you used in determining your opposition.

Mr. **Donohue**. Let me give you one difference and one similarity. The big difference is that a broad-based consumption tax that does not fall on a dozen products or five products is shared by a much greater percentage of the American consumer and, therefore, the reduction of the deficit—which is the stated intention—would be shared by more citizens.

At the same time, understand that a consumption tax—whichever of the three types that you mentioned—falls in a regressive way because the effect on the lower income people is more significant than it is on those in the upper income brackets.

That is not to say I am suggesting that you address this problem in a very progressive way; I am just saying that excise taxes are most unfair because they are regressive for a selected group of consumers.

Consumption taxes are also regressive, but they are paid by a much broader group of consumers.

Senator **Daschle**. So, from that point of view, you would view the consumption tax as a more favorable tax?

Mr. **Donohue**. You would have the same amount. Let's say you had $19 billion or $18 billion under discussion. If the broadest base of consumers were to pay that $19 billion, the adverse effect on the lower income persons would be less; and the spreading of the effect would be greater. Yet it would still be regressive.

Senator DASCHLE. I assume that I would be safe in categorizing one commonality among all the witnesses on this panel, and it is a fairly safe bet, I assume that you all would support a broad-based tax over an excise tax.

Now, the question is: Of the broad-based tax options we have—a surtax, a change in the rates, a value added tax, any kind of consumption tax, I suppose—is there a commonality of view in that regard, as well.

Mr. Osterman, do you have a particular preference of those mentioned?

Mr. OSTERMAN. You know, the Tax Committee did an excellent job when they came out with the Tax Reform Act of 1986. I don't know what a one percent increase in the income tax rate of the individual amounts to.

Senator Packwood, you were the chairman of that committee. You might be able to tell us what a one percent increase in the income tax——

Senator DASCHLE. Briefly, is that a yes or a no?

Mr. OSTERMAN. Yes, I would rather be for that than a tax——

Senator DASCHLE. Which of those suggested appeals to you the most?

Mr. OSTERMAN. I would say an income tax increase.

Senator DASCHLE. Income tax? Does anybody disagree with that?

Mr. DONOHUE. Senator, I don't want to disagree, and I was the first to say that I recognized that of all other options that are out, the best thing to do is a broad-based tax. I think that you would hear from as many people as you are hearing from today about excise taxes, as to how that tax ought to be applied; but my feeling is it should be something that is not a new system necessarily that requires a whole new mechanism and that is easy to collect.

That is one of the things that we have not talked about. We have a lot of people in this country not paying taxes, and it ought to be one that is borne most fairly across the board; and I think that it has to be picked after some more analysis is done.

Senator DASCHLE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Gentlemen, that has been helpful to us, and we appreciate your contribution.

We have another panel of witnesses yet to be heard.

Our next panel will consist of Mr. Howard Bell, President of the American Advertising Federation; Mr. Edward O. Fritts, President and Chief Executive Officer of the National Association of Broadcasters; Mr. James Supica, President of United Construction Company, testifying on behalf of the Associated General Contractors of America; and Mr. S.M. True, Jr., President of the Texas Farm Bureau, testifying on behalf of the American Farm Bureau Federation.

Mr. True is an old friend of mine. He is a man who has done a great deal of pro bono work on behalf of farm associations and we are pleased to have him here.

All right, gentlemen. We will proceed. Mr. Bell is the President of the American Advertising Federation. Mr. Bell.

STATEMENT OF HOWARD BELL, PRESIDENT, AMERICAN ADVERTISING FEDERATION, WASHINGTON, DC

Mr. **Bell**. Thank you, Mr. Chairman, and members of the committee.

The American Advertising Federation is a nonprofit association that includes within its membership all of the various elements of the advertising industry, including national advertisers, agencies, newspaper and magazine publishers, radio and television broadcasters and networks. The Federation also represents the interest of 42,000 advertising practitioners across the country who are members of the 219 local advertising federations in AAF. It is on behalf of these members that I testify today in opposition to all attempts to reduce or restrict the deductibility of advertising expenditures as an ordinary cost of doing business.

In addition, the views expressed in this testimony are supported by the American Association of Advertising agencies, the Association of National Advertisers and the Magazine Publishers Association. And I believe representatives of these associations are also present here today.

Advertising is the driving force of our consumer economy. Advertising fosters competition among and between brands. It provides us with greater choices and encourages product innovation. And without a doubt, advertising lowers costs to consumers.

Placing restrictions on advertising tax deductions will increase the cost of advertising, and, therefore, reduce its competitive and information benefits to the marketplace and the consumer.

Importantly, economic data demonstrates that a restriction on advertisement deductions would seriously harm the American economy.

A Wharton Econometric Study commissioned by the Federation and the AAAA and ANA predicts that a 20 percent reduction in advertising tax deductions could result in a reduction of advertising expenditures of nearly 5 percent. This reduction in advertisement expenditures, according to Wharton, would cause over a 5-year period a loss of $522.00 per household in real disposable income and a loss of $76.7 billion in output, as well as a $5.1 billion rise in the national debt by 1994.

And, Mr. Chairman, I would respectfully request that the Wharton study be made a part of this record, and we would be glad to supply additional copies to the members of the committee, and I believe at times in the past we have done so.

The Chairman. Without objection, that will be fine.

Mr. **Bell**. Thank you.

[The Wharton study follows:]

THE MACROECONOMIC COSTS OF LIMITING THE DEDUCTIBILITY OF ADVERTISING EXPENSES

PREPARED BY

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JUNE 5, 1986

WHY CONSIDER LIMITING THE DEDUCTIBILITY OF ADVERTISING EXPENSES?

The tax reform proposal, as enacted by the U.S. House of Representatives (H.R. 3838) and as reported by the Senate Finance Committee, includes the provision that only 80 percent of business real expenses and business entertainment expenses would be deductible. While neither the House nor the Senate versions of the tax reform proposal extend the 80 percent deductibility limit to advertising expenses, such proposals have been reported in the press. The proponents of limiting the deductibility of advertising expenses apparently believe that such disallowance would not adversely affect the economy.

As an alternative to simply disallowing the deductibility of 20 percent of advertising expenses, proposals have been advanced which would require that 20 percent of advertising expenses be capitalized and recovered over a five-year period. The rationale requiring the capitalization of 20 percent of advertising expenses is not clear. Specific advertising executions rarely are used for even one year, and even when a campaign continues over a longer period, new material must be developed.

Much advertising is designed to be used for a very short time period, such as the weekly food special advertising in newspapers, advertising special short-duration sales, and almost all direct-mail advertising. Even when the advertiser's intent is to use specific advertising as long as it is effective, previous studies have shown that this effectiveness deteriorates fairly quickly (Chaiet, 1982; Reid, 1983; and Tele Research, 1968).

One possible rationale for amortizing 20 percent of advertising expenses would be that advertising serves to build goodwill for the firm and to increase its market value. Some advertising in fact is intended to build goodwill for the company, but this is a small part of total advertising. Most advertising is designed to generate current sales and revenue, which is subject to taxation as ordinary income, and, therefore, advertising expenses should be deductible as part of the cost of sales.

Those opposed to advertising allege that advertising leads to higher product prices, allows firms to gain excessive market power, helps to discourage new entrants into existing markets, and, at best, merely helps a firm capture a larger share of an existing market. While our primary objective is to demonstrate quantitatively the positive contribution that advertising makes to economic growth, the existing academic literature does not support the other negative allegations regarding advertising.

While consumers ultimately do bear the cost of all expenses related to the production, distribution, and retailing of the products that they buy, advertising costs are only one component of selling costs and often only a small component of total sales costs. Reducing advertising outlays can lead to offsetting or greater increases in other sales costs (Aaker and Myers, 1975). For example, advertising helps reduce retail distribution costs by providing customers with product information. As a result, retailers need not bear the cost of educating their sales force on the relative merits of a given product, and advertising may make feasible the use of lower cost self-service (or limited service) retailing for the product.

The existing evidence does not support the view that advertising allows firms to charge higher prices (Backman, 1967; and Wittink, 1977), and heavily advertised brands typically have lower retail markups than unadvertised (or lightly advertised) brands (Steiner, 1973; Harris, 1979; and Reekie, 1982). Finally, the prohibition of advertising for eyeglasses and drugs by some states has been shown to lead to higher prices for these products than in states which permitted advertising (Benham, 1972; and Cady, 1976).

Advertising does not appear to lead to markets being dominated by a few large firms (Telser, 1964; and Nelson, 1975). Further, advertising does not appear to make it difficult for new firms to enter established markets (Ornstein, 1978). In fact, there is evidence that new products enter more easily into markets where advertising is heavily used (Telser, 1964).

This study demonstrates that, in the aggregate, advertising increases the size of the U.S. economy. Advertising does help the firm advertising capture a larger share of its market (i.e., help the firm obtain a larger slice of the pie), but, in many cases, it can also increase the size of the market (i.e., make the pie bigger). In mature or saturated markets, advertising can only help the firm obtain a larger market share, but, in growing markets, advertising may accelerate the market's growth.

Advertising can contribute to overall economic growth in several ways. Much advertising provides information useful to consumers in deciding whether and how to spend their income. Advertising also can bolster consumer confidence, leading to higher levels of consumer spending. The information content of advertising, which would tend to lead consumers to spend more (or to spend now rather than later), includes that which identifies new products, identifies the features and benefits of the products, announces the availability of favorable credit terms, cash rebates, lower prices, or other special purchases terms, and provides the location of retail outlets.

Much advertising, particularly that used for high-priced items like autos, attempts to convince consumers that conditions are now favorable for them to buy today rather than waiting until a later date. As has been demonstrated by the consumer surveys conducted by the University of Michigan Survey Research Center, if consumer confidence is raised, then consumers will spend more of their income, leading to greater total consumer sales, which leads to more jobs and higher income. Much of this higher income, in turn, is spent, leading to still more jobs and income being created. This process of a spending increase--generating more jobs and income, which generates still more spending and so forth--is called the multiplier process. It is typical that an initial one-dollar increase in spending ultimately would generate close to two dollars of new income and expenditure via this multiplier process.

If the federal tax laws were changed to limit the deductibility of advertising expenses, the after-tax cost (price) of advertising would increase. This higher after-tax cost of advertising would result in a reduction in the volume of advertising done by business. This would have a direct negative effect on the economy because, as a consequence of the reduced use of advertising by business, revenues would be reduced for advertising agencies, newspapers, periodicals, radio and TV networks and stations, billboard advertising, and third-class-mail advertising. These businesses, in turn, would be forced to cut back on their workforce, thereby forcing people into the ranks of the unemployed.

While the loss of income and jobs in those businesses directly supported by advertising outlays would be substantial, the reduction in advertising will have a much larger impact on the economy because consumers can be expected to respond by reducing their expenditures on goods and services. Therefore, the higher after-tax cost of advertising will ultimately link to a reduction in the growth rate of markets (i.e., the pie will be smaller).

The only alternative to this scenario is that advertisers try to pass the higher after-tax cost of advertising on to the consumer in the form of higher product prices. If advertisers attempted to pass the higher costs on to the consumer, consumers would reduce their demand for these products owing to the higher prices. Also, the real value of consumer incomes would be eroded by these higher prices, leading to a drop in consumer demand and a slowing of growth. Again, the pie would be smaller.

METHOD OF DETERMINING ADVERTISING'S CONTRIBUTION TO ECONOMIC GROWTH

Ultimately, we wanted to determine the impact of raising the after-tax cost of advertising on overall economic growth. To accomplish this, we first had to estimate the sensitivity of advertising volume to changes in the price (after-tax cost) of advertising. Then we estimated the sensitivity of consumer expenditures to changes in advertising volume. This second step yielded a change in the percentage of income spent due to a given change in total advertising volume. Finally, Wharton's Long-Term Model of the U.S. economy, which is described in Appendix A, was used to estimate the overall macroeconomic effects of the change in the percentage of consumer income spent due to a change in advertising volume.

Advertising expenditure in current dollars and unit advertising price index data for 1960 through 1985 were obtained from Robert J. Coen of McCann-Erickson, Inc. These data included advertising in newspapers, magazines, television, radio, outdoor, direct mail, and other miscellaneous media. Advertising volume was calculated as the dollar expenditures divided (deflated) by the unit advertising price index. The advertising volume data are measured in billions of constant dollars. These data are presented in Appendix B.

We used regression analysis to determine the sensitivity of advertising volume to changes in the price (after-tax cost) of advertising. The estimated regression is shown in Appendix C. This regression indicates that a 1.0 percent increase in the price of advertising will result in approximately a 0.7 percent decrease in advertising volume. If 20 percent of advertising expenses were not deductible and the marginal corporate tax rate was 34.5

percent (halfway between the House (36 percent) and Senate (33 percent) tax reform proposals), the after-tax cost (price) of advertising would rise by 6.9 percent. The regression analysis implies that, as a result, advertising volume would decline by 4.8 percent.

The regression used to determine the change in the share of the consumer dollar which is spent due to a change in advertising volume is presented in Appendix D. The equation shown in this appendix is normalized on the share of permanent disposable income net of imputations which is not spent (i.e., is saved). While the ultimate outcome is not obvious from the regression results shown in Appendices C and D, a 1 percent increase in the price (after-tax cost) of advertising would cause consumer spending as a percentage share of disposable income to decline by 0.035 percentage point. For the case where 20 percent of advertising expenses are not deductible and the marginal corporate tax rate was 34.5 percent, the after-tax cost (price) of advertising rises by 6.9 percent and consumer expenditures, as a percentage of disposable personal income, would decline by 0.24 percentage point.

The Wharton Long-Term Model of the U.S. economy was used to estimate the overall economic effects of the induced shifts in consumer spending as a percentage of total personal income. This procedure involved first constructing a baseline scenario which assumed that advertising expenses would remain deductible. Under the baseline scenario, advertising prices were assumed to increase at the same rate as the overall inflation rate (i.e., no increase in real advertising costs). Under this scenario, advertising volumes increased at a rate slightly higher than the growth in permanent constant-dollar personal income.

Alternative macroeconomic scenarios were then prepared which incorporated the impacts of limiting the deductibility of advertising expenses. Two types of scenarios were constructed which would:

1) allow only 80 percent deductibility of advertising expense; and
2) require capitalization of 20 percent of advertising expenses
    a) assuming a 10 percent nominal discount rate and
    b) assuming a 20 percent nominal discount rate.

The effects of these changes on various macroeconomic variables are calculated by comparing the results obtained from the Wharton Long-Term Model under the alternative scenarios with those obtained under the baseline.

MACROECONOMIC IMPACTS OF ALLOWING ONLY 80 PERCENT DEDUCTIBILITY FOR ADVERTISING EXPENSES

In evaluating the impacts of allowing only 80 percent deductibility of advertising expenses as part of tax reform, we assumed that the marginal corporate income tax rate would be reduced from the current 46 percent rate to a 34.5 percent rate (halfway between the rates proposed in the House and Senate versions of H.R. 3838). The estimated negative impacts would be larger under the current 46 percent marginal rate. Disallowing the deductibility of 20 percent of advertising expenses has the same effect as increasing the price of advertising by 6.9 percent. This implicit increase in the price of advertising results in approximately a 4.8 percent decline in advertising volume, which in turn leads to a decline in the percentage of personal disposable income devoted to consumer expenditures. Assuming the laws were changed in the beginning of 1986, the induced changes are shown in Table 1.

TABLE 1

PERCENTAGE POINT CHANGE IN THE PERCENTAGE OF REAL INCOME SPENT ON GOODS AND SERVICES DUE TO ALLOWING ONLY 80 PERCENT DEDUCTIBILITY OF ADVERTISING EXPENSES

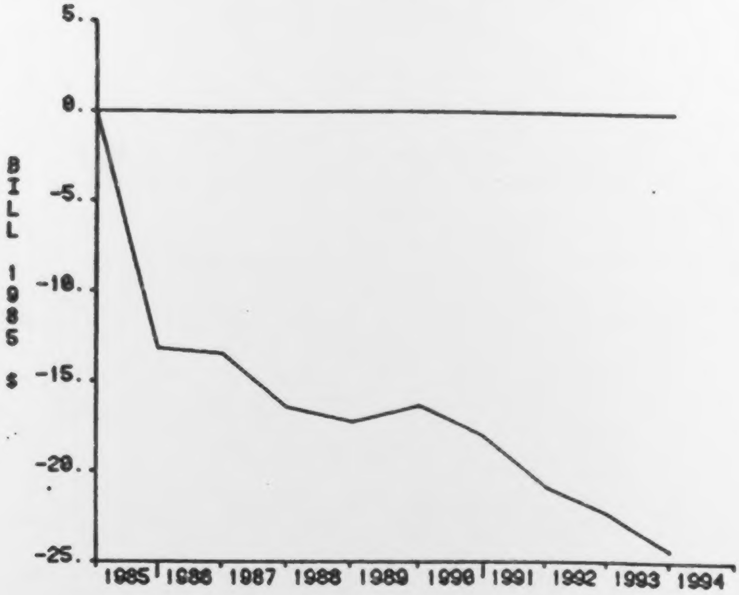
Year	Percentage Point Change
1986	-.178
1987	-.205
1988	-.233
1989	-.237
1990	-.211
1991	-.227
1992	-.239
1993	-.236
1994	-.235

The reduction in the percentage of personal income spent on goods and services implies a drop in the total demand for goods and services and thereby a drop in U.S. output (GNP). This initial drop in output implies that less revenue is available to producers, leading to cutbacks in employment and other producer outlays. These cutbacks produce a further drop in personal income and spending. This multiplier process causes the final impact to be almost double the initial impact.

Total output (GNP) losses due to the reduction in consumer spending total $76.7 billion (1985 dollars) during the first five years after the change (1986-90). By 1994, the total GNP loss cumulates to $162.1 billion (1985 dollars). Figure 1 shows the yearly losses in output (real GNP) due to allowing only 80 percent deductibility of advertising expenses.

FIGURE 1

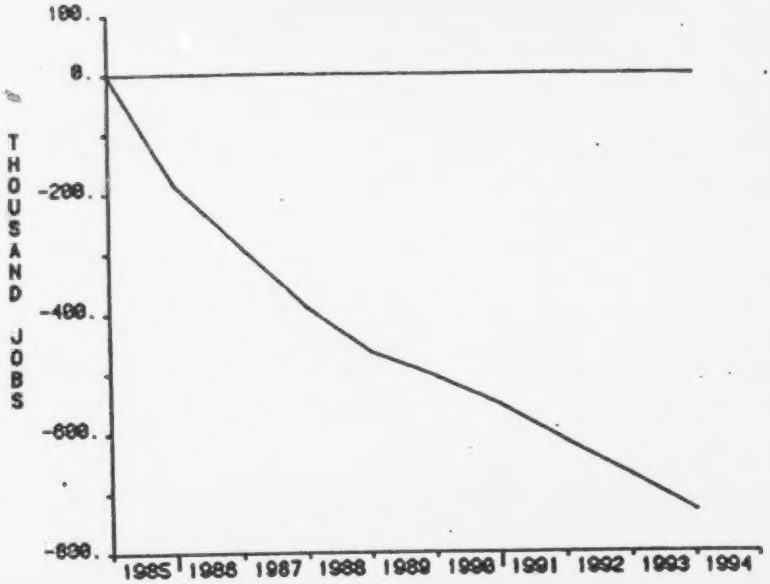
ANNUAL OUTPUT LOSSES DUE TO ALLOWING ONLY 80 PERCENT DEDUCTIBILITY OF ADVERTISING EXPENSES



These output losses translate directly into job losses. In the initial year of the tax law change (1986), job losses are 185,100. By the fifth year (1990), job losses mount to 506,600 and, by the ninth year (1994), the total job loss reaches 730,620. Figure 2 shows the yearly job losses.

FIGURE 2

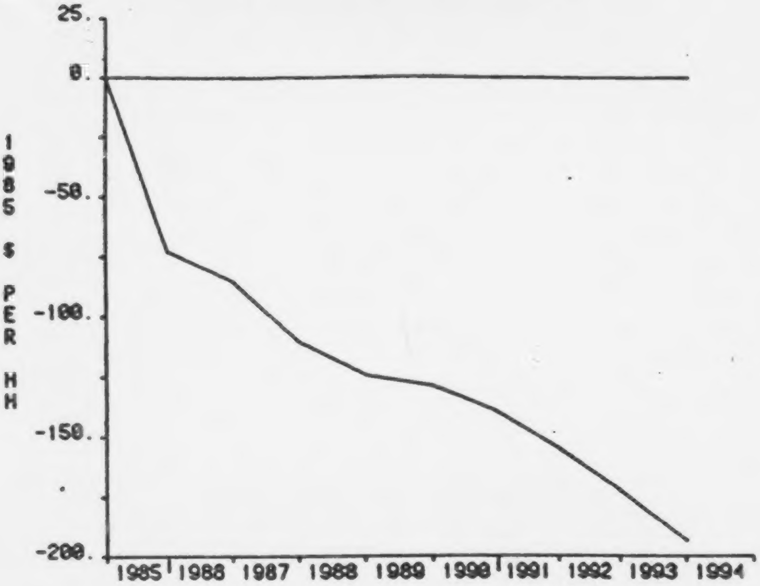
ANNUAL JOB LOSSES DUE TO ALLOWING ONLY 80 PERCENT
DEDUCTIBILITY OF ADVERTISING EXPENSES



Reductions in output and job losses imply a loss in household income. Over the first five years (1986-90), real income per household is reduced by $522.49 (1985 dollars) due to the limitation on advertising expense deductibility. During the entire nine-year simulation period (1986-94), the loss in real income per household cumulates to $1183.94. While these average losses per household are substantial, the losses experienced by households whose members lost their jobs would be much higher. Figure 3 shows the yearly losses in real income per household. These real income-per-household losses imply a loss in total real personal income of $48.0 billion (1985 dollars) over the 1986-90 period and a loss of $112.8 billion (1985 dollars) over the 1986-94 period.

FIGURE 3

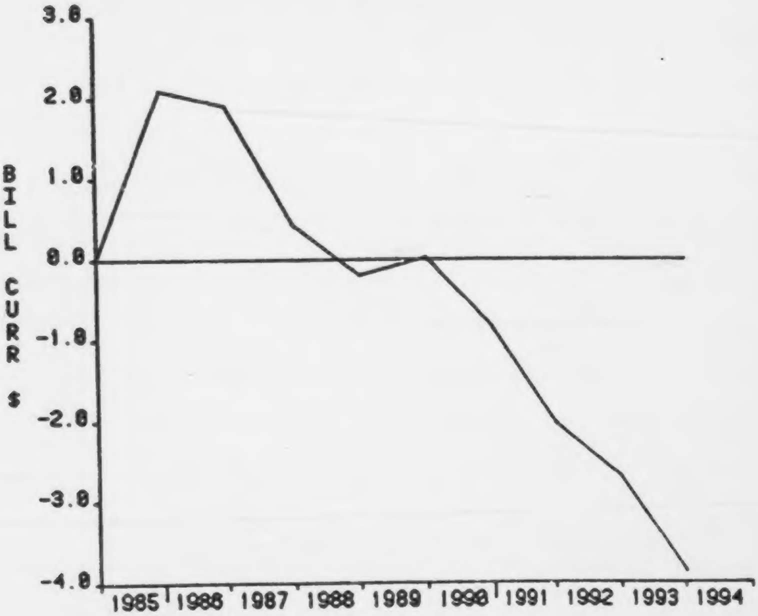
ANNUAL REAL INCOME PER HOUSEHOLD LOSSES DUE TO ALLOWING ONLY 80 PERCENT DEDUCTIBILITY OF ADVERTISING EXPENSES



The output, job, and income losses result in a substantial reduction in federal government receipts. The output and income losses reduce the tax base, while job losses imply an increase in transfer payments such as unemployment compensation. After three years, these losses more than offset the federal revenue gains arising from allowing only 80 percent deductibility of advertising expenses. By 1994, the annual net loss in federal government receipts is $3.9 billion and the cumulative net loss is $5.1 billion. The discounted present value of the net change in federal government receipts over the 1986-94 period is -$0.8 billion[1]. The annual changes in net federal government receipts are shown in Figure 4.

FIGURE 4

ANNUAL CHANGES IN NET FEDERAL GOVERNMENT RECEIPTS DUE TO ALLOWING ONLY 80 PERCENT DEDUCTIBILITY OF ADVERTISING EXPENSES



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[1] Discounted back to 1986 using a 10 percent discount rate.

MACROECONOMIC IMPACTS OF REQUIRING CAPITALIZATION OF 20 PERCENT OF ADVERTISING EXPENSES

The proposals that would require the capitalization of 20 percent of advertising expenses over a five-year period have been vague as to precisely how the capitalized component would be depreciated (recaptured). We have assumed that the capitalized portion could be added to expenses in five equal increments starting in the year after the advertising took place. The after-tax cost of capitalization depends on the discount rate which would be applied by the firms that had to capitalize the advertising expense. Since different firms use different rates based, in part, on their expected internal rate of return, we have considered two discount rates which should bound the rates which would be used by different firms: a 10 percent nominal discount rate, which is often used by the federal government, and a 20 percent nominal discount rate, which is commonly used by business. Given that inflation is expected to average about 5 percent during the upcoming decade, these nominal discount rates imply a real discount rate of between 5 and 15 percent.

With a 10 percent discount rate, requiring the capitalization of 20 percent of advertising expense has the same effect on the after-tax cost of advertising as allowing only 95.1 percent of advertising expenses to be deducted. Under a 20 percent discount rate, capitalization has the same effect on after-tax costs as allowing only 91.7 percent of advertising expenses to be deducted. Under the 10 and 20 percent discount rates, after-tax costs (prices) of advertising are increased by 1.7 percent and 2.8 percent, respectively, due to a 20 percent capitalization requirement. Table 2 shows the percentage point decreases in consumer spending as a share of personal income due to requiring capitalization of 20 percent of advertising expenses.

TABLE 2

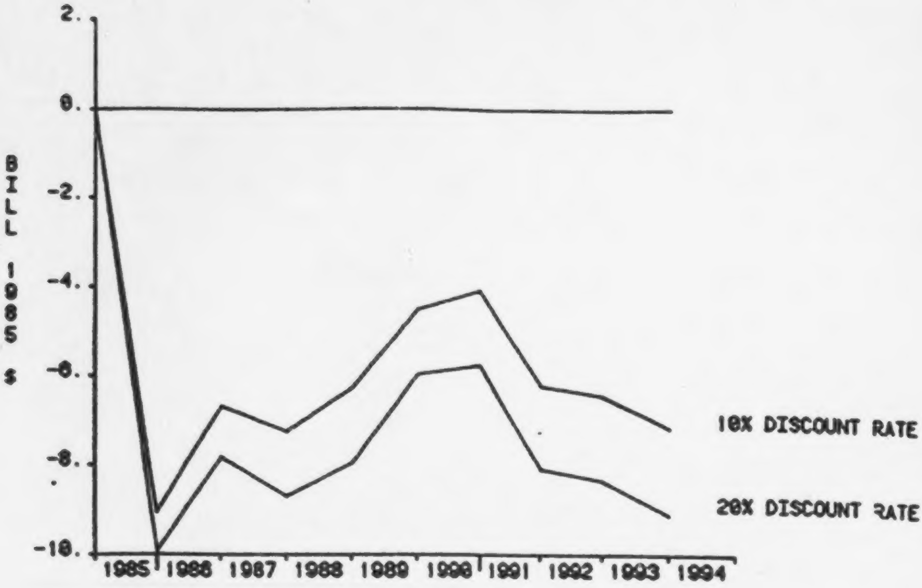
PERCENTAGE POINT CHANGE IN THE PERCENTAGE OF REAL INCOME SPENT ON GOODS AND SERVICES DUE TO REQUIRING 20 PERCENT CAPITALIZATION OF ADVERTISING EXPENSES

	Percentage Point Change for a Discount Rate of:	
Year	10 Percent	20 Percent
1986	-.044	-.072
1987	-.051	-.084
1988	-.058	-.096
1989	-.059	-.098
1990	-.052	-.086
1991	-.057	-.093
1992	-.060	-.099
1993	-.060	-.098
1994	-.060	-.098

Real output (GNP) losses during the first five-year period (1986-90) range between $33.7 billion and $40.4 billion (1985 dollars) for the 10 percent and 20 percent discount rates, respectively. By the end of the simulation (1994), cumulative real GNP losses climb to between $57.7 and $71.7 billion (1985 dollars). The yearly output losses due to requiring capitalization of 20 percent of advertising expenses are shown in Figure 5.

FIGURE 5

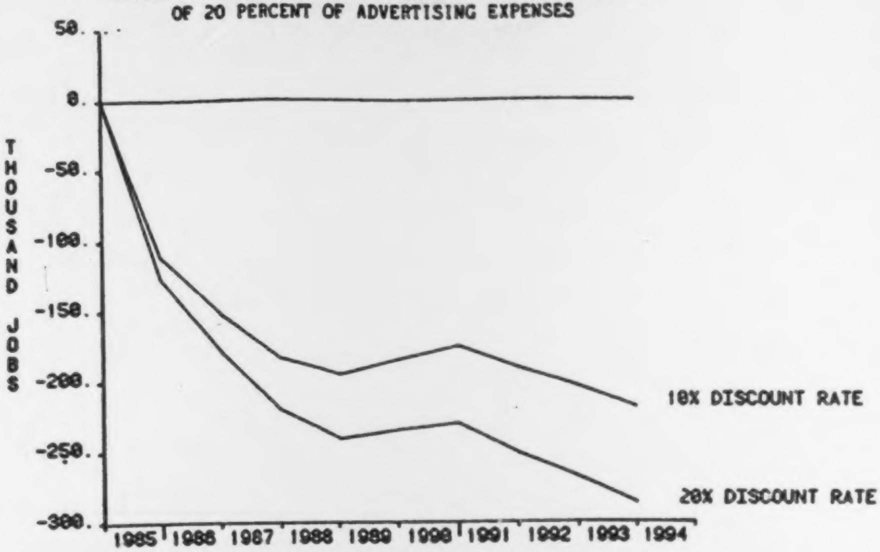
ANNUAL OUTPUT LOSSES DUE TO REQUIRING CAPITALIZATION OF 20 PERCENT OF ADVERTISING EXPENSES



In the year of the tax law change (1986), job losses are between 110,810 and 126,750. By the end of the fifth year (1990), job losses climb to between 184,560 and 234,250, and by the end of the simulation (1994) job losses total between 218,620 and 286,440. Figure 6 shows the annual job losses.

FIGURE 6

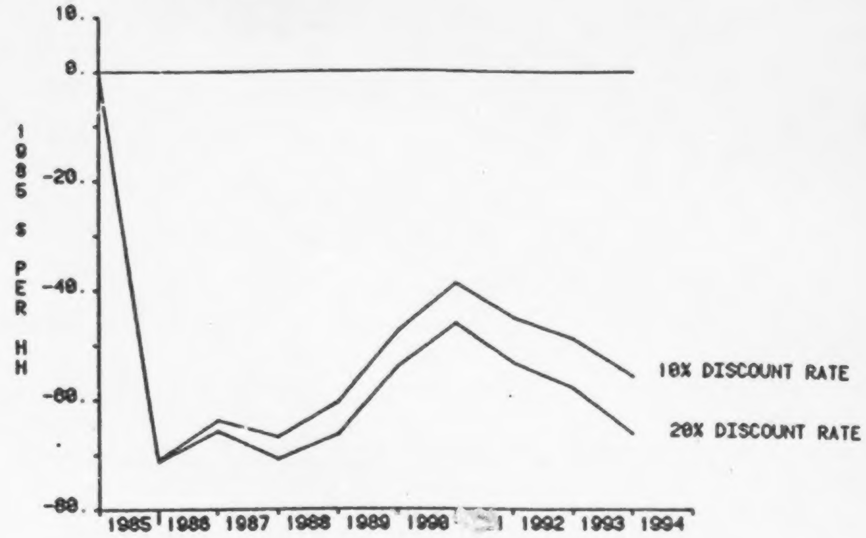
ANNUAL JOB LOSSES DUE TO REQUIRING CAPITALIZATION OF 20 PERCENT OF ADVERTISING EXPENSES



Job and output losses result in household income losses. Over the first five years following the tax law change (1986-90), real income per household is reduced by between $309.76 and $328.22 (1985 dollars) owing to requiring capitalization of advertising expenses. By the end of the simulation (1994), cumulative household income losses mount to between $498.19 and $551.73 (1985 dollars). These losses are an average over all households. For households in which one of its members loses a job, the income loss will be much higher. The yearly losses in real income per household are shown in Figure 7. These real income losses per household imply large losses in aggregate real personal income. Over the 1986-90 period, total real personal income is lower by between $28.5 billion and $30.2 billion (1985 dollars), while over the 1986-94 period, real personal income losses are between $47.5 billion and $52.6 billion (1985 dollars).

FIGURE 7

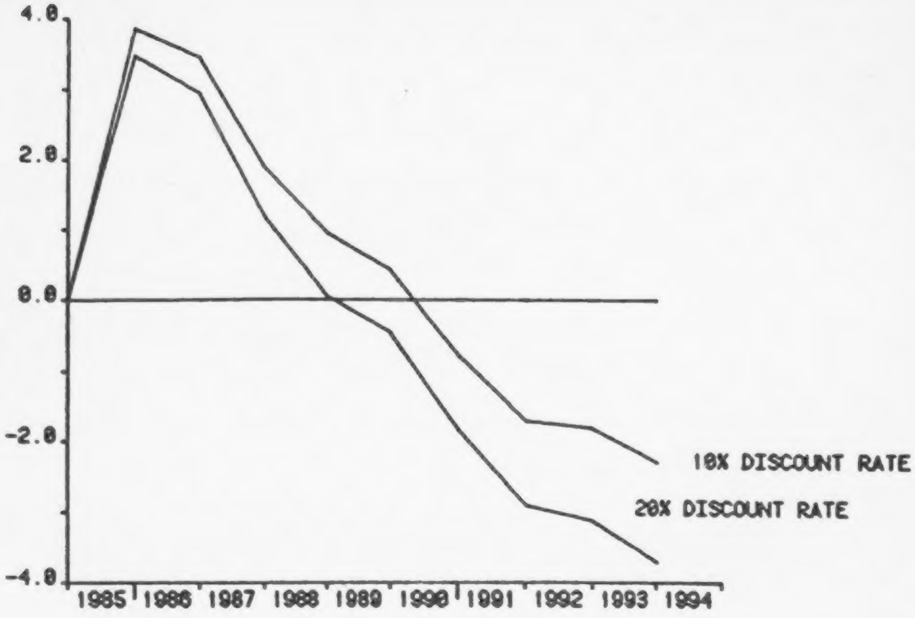
ANNUAL REAL INCOME PER HOUSEHOLD LOSSES DUE TO REQUIRING CAPITALIZATION OF 20 PERCENT OF ADVERTISING EXPENSES



Due to income and job losses, the federal government tax base declines and its transfer payments rise, resulting in an increase in the federal debt. After four to five years, these losses more than offset the federal revenue gains arising due to requiring capitalization of 20 percent of advertising expenses. By 1994, the annual net loss in federal government receipts is between $2.3 billion and $3.7 billion. Figure 8 shows the annual changes in net federal government receipts.

FIGURE 8

ANNUAL CHANGES IN NET FEDERAL GOVERNMENT RECEIPTS DUE TO REQUIRING CAPITALIZATION OF 20 PERCENT OF ADVERTISING EXPENSES



DIFFERENTIAL IMPACTS ON SMALL BUSINESS

The impact of limiting the deductibility of advertising expenses should have a larger negative impact on small businesses than on large businesses. Large businesses may be able to escape the higher costs by changing their method of advertising (e.g., if telephone sales/advertising costs can be fully deducted because the IRS rules these are sales expenses, large firms may increase their use of telephone sales/advertising). Small local firms typically make use of only conventional media (newspaper, third-class mail, etc.) and are less likely to be able to escape the tax.

Many new small firms enter existing markets with the help of advertising. By limiting the deductibility of advertising, it will make it more expensive for new small businesses to obtain a sufficient market share. These higher costs of entering markets will discourage the creation of new businesses and inhibit competition.

DIFFERENTIAL IMPACTS ON CONSUMER GOODS INDUSTRIES

One of the objectives of tax reform is to provide a level playing field. Advertising is an essential and substantial component of selling costs for most firms that sell to consumers. Firms that sell goods and services to other businesses typically do not rely as extensively on advertising to reach their customers. By limiting the deductibility of advertising expenses, firms selling to consumers will experience higher sales costs and reduced profitability relative to firms selling to businesses. Therefore, by limiting the deductibility of advertising expenses, Congress would be changing the tax code to discriminate against firms selling to consumers. This clearly is inconsistent with the overall neutrality objectives of tax revision.

POTENTIAL IMPACTS OF STATE AND LOCAL GOVERNMENT TAXATION OF ADVERTISING OUTLAYS

Several state and municipal governments have considered taxing advertising outlays. These proposed taxes have been in the form of sales, use, service, or gross receipts taxes. Such taxes would raise the after-tax cost of advertising just as the proposed federal limitation of advertising expense deductibility would raise these costs. While our formal analysis focused on the effects of the federal tax law change, the expected impacts of a state or municipal tax would be at least as large if not larger than for a comparable percentage change in after-tax costs due to the federal tax law change.

A state (or municipality) may be able to tax advertising only in local media (newspapers, local TV and radio spots, direct mail originating within its borders, and outdoor advertising). As a result, advertising expenditures may be reallocated to use non-local media such as national magazines, non-local TV and radio, and non-local direct mail. In this case, the state or municipality may drive businesses, engaged in or heavily supported by advertising, outside its borders. If this happened, the relative job losses ould be much greater at the local than at the national level.

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APPENDIX A

WHARTON ECONOMETRICS' MACRO MODELS OF THE U.S. ECONOMY

Wharton maintains separate U.S. macroeconomic models to generate its short-term and long-term forecasts of the U.S. economy: the Wharton Quarterly Model and the Wharton Long-Term Model. Wharton maintains two models because economic models, by nature, only approximate the workings of the economy. The complexity of the real economy makes it impossible to analyze all the relationships among economic variables. Construction of an econometric model begins with an identification of the types of studies in which the model will be used. The applications of the model play a major role in determining the relationships to be emphasized in the design of the model.

The Wharton Quarterly Model is used to prepare forecasts over a 10- to 12-quarter horizon. The primary purpose of these forecasts is to anticipate cyclical fluctuations in economic activity. That is, the forecast seeks to predict the movement of such economic aggregates as gross national product, the unemployment rate, and the inflation rate on a quarter-by-quarter basis. Consequently, the Quarterly Model contains many variables and relationships which monitor the shortrun sensitivity of the economy. The theoretical interpretation underlying this model can be summed up as follows. In the short-run, the overall level of economic activity is primarily determined by the aggregate level of final expenditures. Production is assumed to rise or fall in response to changes in the level and composition of final demand.

The Wharton Quarterly Model forecast is rated most accurate by a wide margin among the major national forecasts. Dr. Stephen K. McNees, Vice President and Economist at the Federal Reserve Bank of Boston, has become known as the unofficial "arbiter" of forecasting accuracy in the United States. Over the last 10 years, he has prepared comparison studies of forecasting accuracy based on the results of the major economic forecasters. His most recent study, done jointly with John Ries, was published in the New England Economic Review (November/December 1983).

The table below summarizes the results of Dr. McNees' latest study as they apply to the three major commercial forecasters. The relative value of these model-based forecasts for the second year out is higher than during the first year, given the lack of high-quality alternative information. Therefore, the decision makers who use econometric forecasts rely more heavily on the model forecasts during the period 5-8 quarters ahead. We show both the overall and 5-8 quarter results.

PERCENT OF TIME EACH SERVICE WAS ACCURATE

	Quarters 1-9	Quarters 5-8
Chase	13.4	5.9
DRI	19.0	9.2
Wharton	67.6	84.9

These results clearly indicate the superior performance of the Wharton Econometrics forecast.

The Wharton Long-Term Model is designed to forecast economic activity over a 5- to 10-year horizon. The theoretical underpinnings of this model reflect the theory that the supply side--production relationships and the availability of factor inputs--is paramount in determining the long-run growth potential of the economy. The Long-Term Model, however, is designed to project the actual growth path of the economy rather than the potential growth path. It includes a fully specified demand sector. Thus, although the Wharton Long-Term Model emphasizes the supply side of the economy, especially in comparison to short-term forecasting models, it also provides a framework incorporating detailed supply and demand relationships. Only in such a framework can the interaction of supply and demand variables be adequately investigated.

The specification of the Long-Term Model preserves certain fundamental relationships which have characterized U.S. economic growth in the postwar period. These relationships include constant returns to scale in production, and the long-run constancy of such ratios as the personal saving rate and the wage share of national income. At times, it was necessary to sacrifice some short-term sensitivity in these specifications in order to enhance the long-term properties of the model. As a result, the near-term projection of the Long-Term Model is aligned with the most recent forecast of the Wharton Quarterly Model. This alignment permits us to take advantage of the short-term sensitivity and accuracy of the Quarterly Model in formulating the initial years of the long-term forecast.

APPENDIX B

ADVERTISING EXPENSE, PRICE, AND VOLUME DATA

	ADEXP$	PDAD	ADEXP
1963	13.100	66.923	19.575
1964	14.150	69.231	20.439
1965	15.250	71.538	21.317
1966	16.630	75.385	22.060
1967	16.870	76.923	21.931
1968	18.090	83.077	21.775
1969	19.420	87.692	22.146
1970	19.550	89.231	21.909
1971	20.700	91.538	22.613
1972	23.210	100.00	23.210
1973	24.980	104.62	23.878
1974	26.620	116.15	22.918
1975	27.900	125.38	22.252
1976	33.300	145.38	22.906
1977	37.440	155.38	24.096
1978	43.330	167.69	25.839
1979	48.780	173.85	28.060
1980	53.550	186.15	28.767
1981	60.430	207.69	29.096
1982	66.580	228.46	29.143
1983	75.850	244.62	31.006
1984	87.820	263.08	33.382

where:

ADEXP$ = advertising expenditures, billions of current $;

PDAD = advertising price index; and

ADEXP = advertising volume, billions of constant $.

RPDGNPEXP = expected inflation rate, percent;

ADEXP = advertising volume, billions of constant $;

YPDNETP = permanent personal disposable income net of imputations, billions of constant $; and

DUM6775 = qualitative shift variable (1 during 1967-75; 0 elsewhere).

The specification for the saving rate equation starts with the equation currently in Wharton's Long-Term Model. This equation includes:

- the ratio of current (transitory) to permanent income, which has a positive effect on the saving rate. This variable is designed to capture the effects of cyclical (transitory) swings in income on consumer spending;
- the ratio of consumer spending on autos relative to permanent income which has a negative effect on savings;
- the share of population aged 45 to 54, which has a positive effect on savings;
- the effective personal tax rate, which has a negative effect on the saving rate;
- a proxy variable for real interest rates (the AAA bond rate less the expected inflation rate), which has a positive effect; and
- a qualitative shift dummy, which captures the abrupt drop in the saving rate after 1975 (between 1975 and 1976, the saving rate dropped from 9.7 percent to 6.8 percent and remained below 6.8 percent through 1985).

This equation explains a large percentage of the variance in the saving rate.

The addition of a real advertising expenditures relative to permanent income variable to the saving rate equation, however, enhances its explanatory power. This variable has the expected negative effect on the saving rate. Advertising seeks to increase the volume of business transacted by the advertiser, and this increase is a measure of the success of a campaign. For example, company X judges the success of its advertising campaign by the increase in business it caused. There are two sources of increased business available to company X: it can either attract current clients away from its competitor, company Y, or it can, through aggressive advertising practices, increase the market by encouraging nonconsumers to buy its products. Enlargement of the market is one of the most important ways in which advertising affects the economy, in that it is the advertising which promotes consumption.

Data on current-dollar advertising expenditures and price indices were provided by McCann-Erickson. The price indices were used to deflate the advertising expenditures series, producing a measure of real advertising expenditures (i.e., a measure of advertising value). Based on a t-statistic of -2.7 with 13 degrees of freedom and an F-ratio of 6.99 with (1,13) degrees of freedom, the variable was determined to be significant and appropriate for the equation. The negative sign on the variable with relation to the saving rate reflects the positive impact of advertising on consumer expenditures.

APPENDIX C

REGRESSION RELATING ADVERTISING INTENSITY TO THE REAL PRICE OF ADVERTISING

$$
\begin{aligned}
\log\left(\frac{\text{ADEXP}}{\text{YPDNETP}}\right) = {} & \underset{(169.0)}{-3.194} - \underset{(3.0)}{0.7056}\ \log\left(\frac{\text{PDAD}}{\text{PDCE}}\right) \\
& - \underset{(6.0)}{0.7061}\ \text{DUM76ON} \\
& + \underset{(5.3)}{.9416}\ (\text{DUM76ON} * \text{DUM28T6285}) \\
& - \underset{(5.3)}{.1221}\ \text{DUM7073} - \underset{(7.0)}{.2157}\ \text{DUM7475}
\end{aligned}
$$

R-Bar Squared = .891 S.E. = .0343 D.W. = 1.03

Period of Fit: 1963-1984

where

ADEXP = advertising volume, billions of constant $;

YPDNETP = permanent personal disposable income net of imputations, billions of constant $;

PDAD = advertising expenditure price deflator;

PDCE = consumer expenditure price deflator;

DUM76ON = qualitative shift variable (1 from 1975 onwards; 0 elsewhere);

DUM28T6285 = time trend (0.2 in 1962, 0.8 in 1985, maximum value of 1.0);

DUM7073 = qualitative shift variable (1 during 1970-73; 0 elsewhere); and

DUM7475 = qualitative shift variable (1 during 1974-75; 0 elsewhere).

Data on current dollar advertising expenditures and price indices were provided by McCann-Erickson. The price indices were used to deflate the advertising expenditures series, producing a measure of real advertising expenditures (i.e., a measure of advertising volume).

The real advertising expenditures equation uses the following variables to explain real advertising expenditures:

- Permanent personal disposable income - The elasticity of this variable is constrained to equal one. This reflects the assumption that advertisers will respond to a change in permanent income with a proportional change in spending. For instance, if permanent disposable income grows, advertisers will increase their expenditures in order to attract their share of the growth in consumer incomes. The ratio of real advertising expenditures to permanent income can be thought of as a measure of advertising intensity.
- Price index of advertising relative to price index of consumer expenditures - This variable enters the equation with a negative sign, implying that the volume of advertising decreases when the cost of advertising increases.
- Qualitative shift variable (1 from 1976 onwards; 0 elsewhere).
- Time trend (0.2 in 1962, 0.8 in 1985, maximum value of 1.0).
- Qualitative shift variable (1 during 1970-1973; 0 elsewhere).
- Qualitative shift variable (1 during 1974-1975; 0 elsewhere).

The last four variables listed reflect the impact of changing advertising media technology, shifts in age composition of the population, changes in the relative use of certain types of media, and changing techniques of marketing over time. These effects are not explicitly modeled because they were not directly relevant to this study. Their effect on advertising intensity can be effectively separated from the price effect through the introduction of dummy variables.

When the dummy variables are excluded from the regression, the regression results are as follows:

$$\log(ADEXP/YPDNETP) = \underset{(915.6)}{-3.249} - \underset{(5.69)}{1.00887} \log(PDAD/PDCE)$$

R-Bar Squared = .568 S.E. = .0830 D.W. = .302

Period of Fit: 1963-1984

APPENDIX D

REGRESSION USED TO DETERMINE CHANGES IN THE CONSUMER SPENDING RATE DUE TO ADVERTISING VOLUME CHANGES

$$
\begin{aligned}
\log\left(\frac{\text{SAVR} - .03}{.13 - \text{SAVR}}\right) = {} & \underset{(0.3)}{-1.1981} + \underset{(6.4)}{28.4700} \log\left(\frac{\text{YPDNET\$}}{\text{YPDNETP\$}}\right) \\
& \underset{(4.8)}{-2.8090} \log\left(\frac{\text{CEDA\$}}{\text{YPDNETP\$}}\right) + \underset{(2.0)}{5.9787} \log\left(\frac{\text{NPT45.54}}{\text{NPT}}\right) \\
& \underset{(5.8)}{-0.3661} \ \text{TXPRTEF} + \underset{(2.2)}{.1787} \ (\text{FRMCSAAA} - \text{RPDGNPEXP}) \\
& \underset{(2.7)}{-2.90732} \log\left(\frac{\text{ADEXP}}{\text{YPDNETP}}\right) + \underset{(2.5)}{.5149} \ \text{DUM6775}
\end{aligned}
$$

R-Bar Squared: .904 S.E. = 0.2145 D.W. = 2.47

Period of Fit: 1963-84

where

SAVR = personal savings as a fraction of permanent personal income net of imputations (YPDSAV$ / YPDNETP$);

YPDSAV$ = personal savings, billions of current $;

YPDNETP$ = permanent personal disposable income net of imputations, billions of current $;

YPDNET$ = personal disposable income net of imputations, billions of current $;

CEDA$ = personal expenditures on autos and parts, billions of current $;

NPT45.54 = population aged 45 through 54, millions;

NPT = population, total, millions;

TXRPTEF = effective personal tax rate, percent;

FRMCSAAA = corporate AAA bond rate, percent;

The presence of dummy variables in the equation reduces the elasticity of the price term from -1.01 to -0.71. A priori, the smaller elasticity appears to be a more reasonable estimate of the sensitivity of advertising intensity to the cost of advertising. Also, introducing these dummies improves the explanatory power of the equation. The dummy variables reduce the standard error by nearly 5%, and increase the Durbin-Watson from 0.6 to 1.03. Additionally, the t-tests (statistics displayed above) show that the dummy variables are all significant, and the F-test (35.37 with (5,16) degrees of freedom) supports the hypothesis that the dummy variables belong in the equation. Finally, it is obvious from the reduction in elasticity that the dummy variables do not magnify the impact of a price increase, but rather do just the opposite. Therefore, the equation selected generates a more reliable and conservative forecast than the one without dummy variables.

Mr. **Bell**. Particularly affected will be older and newer businesses introducing new product lines. New products will not succeed without advertising, and these businesses should be able to fully deduct the cost of this advertising just as they would deduct the cost of training employees to develop and sell these new product lines.

These innovators are responsible for new product advancement as well as effective price competition 'Increasing the cost of advertising limits their ability to compete successfully. That is a risk not worth taking where we would have less competition, fewer choices and higher prices.

The media, depending on advertising for revenue, would be significantly affected. Ratio and television rely exclusively on advertising for revenue, so the results would be disastrous for the broadcast media.

Newspapers and magazines would also suffer great losses as a substantial portion of their revenue is derived from advertising. In fact, the media would be doubly impacted because it frequently is an advertiser itself.

Commercial advertising produces immediate sales, not sales 12 months or more in the future. Advertisers of high ticket durable goods must advertise continuously so that their advertised product is visible when their customer is in the market. Advertisers of less expensive products that are purchased again and again must continuously advertise to maintain high awareness levels of their products. The advertising community can assure you that advertisements simply do not have benefits beyond one year.

Consider, for example, the largest category of advertisements, retail ads, announcing sales that may last a day, a month, or a week. Classified ads, which account for nearly one-third of newspaper revenues, are rendered useless after the sale or transaction has taken place. Real estate and seasonal product ads, such as snow tires, air conditioners, are other examples of such ads having immediate appeal and use.

Finally, the AAF opposes denying deductions for advertising expense for specified product categories, including tobacco or alcoholic beverage advertising. Sponsors of this legislation want the government to suppress truthful commercial speech by making it more costly. We believe the use of the Tax Code to discriminate against one kind of speech violates the First Amendment.

In conclusion, the Federation believes that it has been demonstrated that limiting deductions for advertising expense will damage the economy and fail to bring in the revenue expected.

Mr. Chairman, and members of the committee, thank you for the opportunity to present my statement.

The Chairman. Thank you, Mr. Bell.

Mr. **Fritts**.

[The prepared written statement of Mr. Bell follows:]

UNITED STATES SENATE
before the
Finance Committee
STATEMENT OF HOWARD H. BELL
PRESIDENT
AMERICAN ADVERTISING FEDERATION
ON THE DEDUCTIBILITY OF ADVERTISING EXPENSES

July 16, 1987

Introduction

The American Advertising Federation (AAF) is a national trade association that includes within its membership all of the various elements of the advertising industry. The membership includes national corporations that manufacture and advertise consumer products, major advertising agencies, national newspaper and magazine publishers, radio and television broadcasters, all three networks, 160 college chapters, and approximately 22 other national trade associations with memberships composed of companies engaged in various advertising pursuits. The Federation also represents the "grassroots" of the advertising industry as the parent body of more than 215 local advertising clubs and federations located throughout the United States with a combined membership of approximately 42,000 advertising practitioners. These local organizations, like the AAF, represent a broad constituency, including professionals from advertisers, advertising agencies and media.

SUMMARY OF TESTIMONY

AAF opposes any restriction on the deductibility of advertising expenditures as an ordinary cost of doing business. Advertising is the driving force behind our economy. Advertising fosters competition among and between brands, provides consumers with greater choices, encourages innovation, and results in lower costs to the consumer. Furthermore, advertising is the primary, and sometimes only, vehicle of relaying information to the consumer about available products and services.

The Joint Committee on Taxation along with the House Ways and Means Committee staff have prepared a list of options to raise additional revenue to meet current budgetary goals. Despite the critical role which advertising plays in our marketplace, included in these options is a proposal to limit the deductibility of advertising expenses. In addition to the House Ways and Means Committee, the Senate Finance Committee agreed to take testimony on these revenue options.

AAF maintains that the deductibility of advertising expenses is appropriate and fair, and it ensures a competitive marketplace. We strongly urge members of the Finance Committee to consider problems that will result from placing limitations on the deductibility of advertising expenses, namely that such limitations would lead to cutbacks in advertising, would fail to bring in anticipated revenue, and would negatively impact overall economic growth in this country.

Specifically, AAF argues that limitations on the deductibility of advertising expenses would:

- Not meet the revenue raising targets projected for these proposals and set forth by the Joint Committee on Taxation.
- Inaccurately and unfairly assume that advertising has a life beyond one year.
- Create unfair barriers to businesses wanting to participate in the economy
  - ° advertising would be arbitrarily singled out from other forms of marketing and product promotion
  - ° media would pay a double penalty
  - ° small advertisers, ad agencies and members of the media would be put out of business
  - ° anti-competitive forces would be created making it difficult for new businesses or product lines to enter and compete.
- Create an administrative nightmare.

AAF also opposes denying deductions for advertising expenses for specified product categories, including tobacco or alcoholic beverage advertising. Discriminating against these and other specified companies' advertising, by denying them business tax deductions for advertising expenses, clearly would infringe upon their First Amendment right to engage in truthful commercial speech. Further, AAF is concerned that this will set a dangerous precedent where the tax code will be used to discourage the advertising of other products that the government may disfavor.

LIMITING THE DEDUCTIBILITY OF ADVERTISING EXPENSES WOULD NOT ACHIEVE REVENUE RAISING TARGETS

The Joint Committee options phamphlet estimates that restrictions on the deductions of advertising expenses would raise as much as

$37.9 billion over three years. To the contrary, ample data exists to establish that limiting the deductibility of advertising expenses would lead to substantial cutbacks in advertising, loss of jobs, and an overall significant decline in the growth of the economy resulting in a net revenue loss.

A Wharton Econometric Study commissioned by the American Advertising Federation (AAF), the American Association of Advertising Agencies (AAAA), and the Association of National Advertisers (ANA) and released in June, 1986 concluded that a 20% reduction in advertising expense deductions would result in a job loss of 185,000 in the first year alone. This does not even account for additional amortization of the remaining 80% over two years, a measure contained in the list of options.

Another option seeking to defer for one year or to amortize over four years 20% of deductions also gives rise to the problem of cutbacks in advertising and job loss. In addition, members of Congress may seek to extend a deferral of deductions year after year; and the Wharton study predicts dire long term economic consequences should 20% of all ad tax deductions be eliminated entirely. It estimated that over a five year period there would be a cumulative loss of $522 per household in real disposable income, a cumulative loss of $76.7 billion in output (1985 dollars); and a cumulative $5.1 billion rise in the national debt by 1994.

LIMITING THE DEDUCTIBILITY OF ADVERTISING EXPENSES IS BASED ON THE ERRONEOUS ASSUMPTION THAT ADVERTISING HAS A LIFE BEYOND ONE YEAR

There is no evidence indicating that advertising has a lasting effect of more than one year, and therefore AAF disagrees with the Joint Committee staff that it is appropriate for the government "to provide an assumed allocation of the benefit of such costs by statute." Limiting the deductiblity of advertising expenses would do just that as the rational behind deferring, amortizing or denying deductions rests on the unproven notion that advertising has a benefit extending beyond one year.

The purpose of commercial advertising is to produce immediate sales, not sales taking place 12 months in the future. Advertisers of high ticket, durable goods must advertise continously so that their ad is available when a particular customer is in the market for the product. And advertisers of less expensive products that are purchased again and again must continously advertise to maintain high awareness levels for their products. In fact, consumer research exists to show that consumers quickly forget ad messages after they have been received.*

Consider the following examples where advertising clearly is intended for an immediate and short term impact, and where it clearly would be unfair and inaccurate to limit ad deductions based on the notion that there is a benefit extending beyond one year:

* Retail ads--the largest category of ads, these are announcements of a sale which may last a day, a week or a month.

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* In a famous study conducted by Hubert Zielske of Foote, Cone & Belding in the late 1950's, consumers were exposed to a particular advertisement repreatedly over a 13 week period. Immediately after 13 successive weekly exposures to the advertising, 63% could remember it. However, within only four weeks after the last exposure, the percentage who could remember the advertising was cut in half. After six weeks, it had decreased by two-thirds. Within six months it was forgotten by virtually everyone.

- Classified ads--these ads, which account for 29% of the ad revenue for magazines, are rendered useless after the sale or transaction has taken place.
- Real estate ads--another form of fixed term ad, usually a short term, and clearly less than 12 months.
- Airline ads, competing on price which are continously modified on a competition basis.
- Ads for seasonal products, such as snow tires or air conditioners.

In each of these cases, it would be difficult to argue that a specified portion of the benefits of advertising would be accrued over and beyond one year. Yet the advertising options before this committee assume that because it is impossible to measure the exact lasting power of advertising, the government should arbitrarily assign one to be applied uniformly across all forms of advertising.

It is important to distinguish the reputation or good-will generated by a product or a service from the advertising of that product or service. Advertising importantly conveys current information to consumers about the products and services available; but it cannot create the good-will resulting from a quality product. It is the quality of the product or service delivered that ultimately renders it a reputation among consumers. It is inaccurate to ascribe long term good will to advertising as a basis for delaying tax deductions beyond one year.

LIMITING THE DEDUCTIBILITY OF ADVERTISING EXPENSES WOULD CREATE UNFAIR BARRIERS TO BUSINESSES WANTING TO PARTICIPATE IN THE ECONOMY

All American businesses that advertise would be harmed by a limitation on advertising deductions. Those which rely most heavily on advertising to promote a product or service and relay information to consumers would be impacted most intensely. This includes national advertisers, as well as smaller advertisers and media, newer businesses, and older businesses with new product lines.

These options discriminate against advertising and those sellers that rely on advertising to carry out their business. Many, in an attempt to survive following a restriction on ad tax deductions will redirect their marketing efforts away from advertising. The use of sales persons, with the attendant costs of their training, will become more popular; and the long term benefits may well be beyond one year. Yet it is advertising that is most arbitrarily being singled out for limitations on annual deductions.

Small businesses already face many obstacles. In a competitive economy, they need to advertise to create new markets and to expand their share of existing ones. The failure rate for these businesses already is high; and advertising often is the crucial link to markets, to the consumer, and to sales transactions.

The media, dependent on advertising for revenue, would be strongly impacted in particular. The Wharton Econometric Study predicts that a 20% loss in deductibility would lead to a 4.8% reduction in advertising. Given that television and radio rely exclusively on advertising for revenue, the results would be disastrous for the broadcast medium. Newpapers and magazines also would suffer great losses as a substantial portion of their revenue is derived from advertising as well.

Furthermore, the media would be impacted doubly. Not only do T.V., radio, magazines and newspapers rely on advertising for revenue, but they also are frequently in the position of advertiser themselves. For example, T.V. stations promote new shows, radio stations promote upcoming events, magazines and newpapers promote themselves.

Because advertising is the principle means by which newer businesses and older businesses with new product lines introduce their innovations into the marketplace, limiting advertising deductions would reduce their ability to compete. The risks of innovation would be that much greater--resulting in less competition, fewer choices for consumers, and higher prices.

Advertising stimulates sales. And new products, requiring new markets or sometimes a share of an older market, depend on advertising to compete. At this critical stage, increased costs in marketing a new product or service would only exacerbate an already risky situation, in which most new businesses/product-lines fail.

LIMITING THE DEDUCTIBILITY OF ADVERTISING EXPENSES WOULD CREATE AN ADMINISTRATIVE NIGHTMARE

Implementing a system where advertising expenses could not be fully deductible in one year would give rise to whole host of administrative problems. First and foremost, how would advertising be defined? There is no readily usable definition of advertising that could be applied in this situation. How would advertising be distinguished from other forms of promotion? Second, what precedent will this set for amortizing or delaying deductions for other kinds of expenses?

DENYING DEDUCTIONS FOR ADVERTISING EXPENSES FOR SPECIFIED PRODUCT CATEGORIES WOULD BE INAPPROPRIATE AND UNCONSTITUTIONAL

AAF opposes denying deductions for advertising expenses for specified product categories, for example tobacco or alcoholic beverage advertising.

AAF believes that this option is unconstitutional for several reasons. First, it is a defacto ad ban, and the Supreme Court has held that truthful advertising for legal products is protected under the free speech provision of the First Amendment of the Constitution. Central Hudson Gas & Electric Corp. v. Public Commission of New York (1980).

Second, denying advertising deductions for specified product categories results in discriminatory tax policies. Since tobacco and alcohol advertisers are the only business groups that would lose the ability to deduct advertising expenses, this legislation impinges on their First Amendment rights to advertise their products in a truthful manner. The Supreme Court has struck down such discriminatory tax policy in the past. Grosjean v. American Press Company, Inc. (1936).

The ramifications of this option extend far beyond the tobacco and alcoholic beverage industries and into the advertising of all products in general. If Congress denies tax deductions for the advertising of these products it will set a dangerous precedent where the tax code would be used to inappropriately discourage the advertising for other products that are disfavored.

CONCLUSION

The American Advertising Federation urges the Finance Committee to consider the many problems inherent in the revenue raising options that limit advertising deductions. First, there are the economic problems--the anti-competitive forces barring new business/new product entry into the marketplace, the additional costs putting smaller advertisers and media out of business, the discriminatory effects which ultimately will discourage advertising and favor other forms of marketing and promotion, the slow down in economic growth which will fail to bring in anticipated revenue. Next, limiting advertising deductions is based on the false notion that benefits from advertising extend beyond one year. Numerous examples of advertising in this testimony demonstrate this point. Furthermore, advertising is a legitimate cost of doing business. It is one part of a long chain of events that goes into developing and marketing products and services. AAF firmly believes that it has been demonstrated time and again that limiting deductions for advertising expenses will do much damage to the economy and will fail to bring in the revenue expected.

STATEMENT OF EDWARD O. FRITTS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF BROADCASTERS, WASHINGTON, DC

Mr. **Fritts**. Thank you, Mr. Chairman.

I am Edward O. Fritts, President and Chief Executive Officer of the National Association of Broadcasters.

NAB is a nonprofit trade association representing approximately 5000 radio and 940 television stations across the nation. We have a prepared statement which we have filed with the committee and ask that that be included. And we will summarize just with the highlights.

The **Chairman**. Without objection.

[The prepared written statement of Mr. Fritts follows:]

National Association of
NAB
BROADCASTERS

STATEMENT OF EDWARD O. FRITTS
PRESIDENT AND CHIEF EXECUTIVE OFFICER
THE NATIONAL ASSOCIATION OF BROADCASTERS

BEFORE THE

FINANCE COMMITTEE
UNITED STATES SENATE

ON

REVENUE OPTIONS

JULY 16, 1987

Mr. Chairman and members of the Committee, I am Edward O. Fritts, President and Chief Executive Officer of the National Association of Broadcasters. NAB is a nonprofit trade association representing approximately 5,000 radio and 940 television stations across the nation. I appreciate the opportunity to discuss with you proposals to raise revenues by reducing or in some instances eliminating legitimate business deductions for advertising. The proposals to which I refer are contained in the June 25, 1987, report entitled "Description of Possible Options to Increase Revenues" prepared for the Committee on Ways and Means by the staff of the Joint Committee on Taxation and the staff of the Committee on Ways and Means. The notion of raising revenues by limiting deductibility of advertising echoes a similar proposal raised, in the last Congress during this Committee's consideration of tax reform legislation.

BROADCASTING AND ADVERTISING

The NAB strongly opposes any attempt to reduce the deductibility of advertising expenses.

It is crucial at the outset of this discussion to impress upon the Committee the unique role advertising plays in the operation of a radio or television station. The success of a station is a direct function of advertising sold. Unlike other forms of communication, commercial over-the-air broadcasting is supported solely by the sale of advertising time. Any action which creates a disincentive to advertise will be most harmful to the thousands of local radio and television outlets.

Just as broadcasters are solely dependent on advertising revenue to sustain their business, broadcasters are also advertisers. In a highly competitive business, local radio and television broadcasters use advertising to build audience share. Proposals that diminish the ability to advertise will adversely affect all broadcasters, but especially those who are just beginning their operations. You need only realize the monumental problem faced by a new AM or FM radio broadcaster seeking to alert the local audience that there is a new radio station to listen to.

Clearly, broadcasters will suffer a double penalty from any attempt to reduce the deductibility of advertising as a proper business expense.

While most of my testimony will focus on the "business" side of any reduction in deductibility, let me take this moment to stress to the Committee the equally serious consideration of service to the public. All broadcasting stations are licensed to serve in the public interest. This responsibility has given the public local and national news, public affairs programming, public service campaigns and community outreach programs. Loss of advertising revenue will, of necessity, mean a reduction in our ability to serve our communities.

LIFE SPAN OF ADVERTISING

The proposal to reduce the deductibility of advertising is based on the suggestion that some benefit of advertising carries past the year in which the advertising is expensed. There is little or no evidence to support the idea of an extended benefit in advertising. In fact, common sense would seem to dictate the contrary. The overwhelming volume of advertising is designed to alert the consumer to the availability of a certain product, perhaps at a certain location and price. The ability to take advantage of a July 4th sale for a new Chevy, or the price of a pound of peaches in August will do the consumer no good in the following February.

The notion that advertising has an enduring effect is not new.[1] Ground breaking research by Zielske shows that advertising begins to be forgotten immediately after exposure.[2] As a Wharton Econometric study concluded, "even when the advertiser's intent is to use specific advertising as long as it is effective, previous studies have shown that this effectiveness deteriorates fairly quickly."[3] Much research supports the generalization that about three exposures within a short time frame (e.g. four weeks) are most effective.[4]

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[1]. Schmalensee, R., The Economics of Advertising, (Amsterdam, Holland: North-Holland Publishing Company, 1972, p. 121).

[2]. Zielske, Hubert A., "The Remembering and Forgetting of Advertising," Journal of Marketing, January 1959, pp. 239-243.

Many advertisers employ strategies whereby persuasive messages are organized into waves or flights which aim for a cumulative effect which is not achieved by any particular spot. Also, much advertising is specifically intended to be short term in its relevance, for example, the advertising of special sales or clearances. The decay rate or durability of advertising has not been clearly established by statistical researchers. In practice, advertisers employ media planning strategies which lead them to design advertising campaigns which assume that advertising exposures have limited durability in terms of consumer perceptions and recall.

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[3]. Schink, George R. and Sima Fishman, "The Macroeconomic Costs of Limiting the Deductibility of Advertising Expenses," Wharton Econometric Forecasting Associates, Inc., June 1986.

[4]. Krugman, Herbert E., "Why Three Exposures May Be Enough," Journal of Advertising Research: The State of the Art, (New York: Association of National Advertisers, Inc., 1976), pp. 53-56.

UNFAIR TAX CODE TREATMENT

There is no hesitation on my part to remind this Committee that advertising is an "ordinary and necessary expense" for any business. Treating the deductibility of advertising differently than any other ordinary and necessary expense would be discriminatory. Advertising, in its most basic form, is designed to inform the consumer of the availability of goods and services. The sale of those goods and services is the bedrock of our economy.

Any "ordinary and necessary expense" is geared to maximizing the sale of goods and services. A business expense in job training, research and development, public relation and advertising all lead a business to the same goal. In light of that fact, is there any business or tax purpose to be served by discriminating against advertising?

The deduction of "ordinary and necessary expenses" is to be taken in the year in which the business expended money for that activity. In light of that, is it truly sound to suggest that the "useful life" formula be applied only to advertising? Yet, to the extent "useful life" now becomes the measure for deductibility of these expenses, the useful life of R & D, public relations or job training are much more likely to extend beyond the year of the expense than would an advertising expense.

To single out advertising for the purpose of determining deductibility is clearly discriminatory. Allow me to add that the Joint Committee Print justifies an arbitrary 20 percent loss of deductibility under the guise of an "assumed allocation." Yet, the print makes clear that any attempt to attribute an extended useful life to advertising is "difficult." In my opinion a more proper term would be "impossible" or "non-existent."

UNFAIR IN BUSINESS PRACTICE

While the proposal is discriminatory in tax treatment of advertising when compared to other ordinary and necessary expenses, it is also discriminatory among the methods of creating product awareness. Many businesses use advertising and promotional strategies to maximize the attractiveness of their products to the consuming public. Recently, there has been a disturbing trend in the migration of dollars from advertising to promotional activities.

Promotional expenditures are growing at a rate of 20 percent a year, whereas advertising grew at 7.9 percent in 1985 and an estimated 7.6 percent rate in 1986.[5] Since 1980, media advertising has shrunk from 45 cents out of every advertising /promotion dollar to 35 cents. Promotional spending has increased from 22 cents of every dollar to 30 cents. The remainder went to trade promotion.[6]

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[5]. Wall Street Journal, August 26, 1986.

Promotional practices take on a variety of forms. It may be as simple as the use of "cents off" coupons, contests, tie-ins with activities in the community (such as sponsoring a float in a parade) or sponsorship of sports events.
Most firms include a mix of advertising and promotion in their sales plans. The fact is that over the past few years the advertising market for radio and television has not been as robust as we might like. Already there is a migration of advertising dollars to promotion. What is unmistakable is that the deductibility proposal will greatly accelerate this trend. Any disincentive to purchase advertising will lead to greater expenditures in promotional activity. As I stated earlier, this will have a particularly detrimental impact on the broadcasting industry.

Let me be very clear. I am not before you seeking an equivalent tax on promotions. Further, I am not asking you to take any action to promote higher rates of growth in advertising or to seek an exalted position for radio and television advertising. It is essential, however, that the Committee appreciate the impact that the loss of deductibility for advertising will have in the current marketplace. We seek no special assistance, but we request no further impediments be placed in the market.

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[6]. Television/Radio Age, December 8, 1986.

STATE TAX PROPOSALS

It appears that taxing advertising is not a new idea. The proposal to reduce the deductibility of advertising was first discussed in this Committee's consideration of tax reform proposals during the last Congress. More recently, we have witnessed several states seeking additional revenues through taxes on advertising. The state of Florida recently enacted a 5 percent services tax which includes advertising, joining Hawaii, New Jersey and New Mexico. Other states such as Indiana, Mississippi, Nevada and Washington are now looking at similar proposals.

I do not offer the state tax proposals as a defense to the type of proposal suggested in the Joint Committee report. I do want the Committee to be aware that these state proposals will seriously harm employment and may actually reduce net tax revenue because the resulting decrease in sales will reduce revenues from state sales taxes. A federal proposal to reduce deductibility will exacerbate the loss of jobs and the resultant harm to the economy.

A Wharton Econometric study analyzing Florida's recent 5 percent sales and use tax estimated a job loss of over 10,000 positions when the tax is imposed, over 40,000 lost by the end of 1989. If the tax induces some media and advertising companies to leave the state there would be a higher job loss and an initial reduction in personal income of $600 million and $2.6 billion by the end of 1989.

In a survey of Virginia businesses who advertise, the University of Virginia found a state tax on advertising could "adversely affect" state and federal government income tax revenues. Further, such a tax would lead to a decline in sales of between $55.6 million and $66.7 million; with a resultant loss in state sales tax revenue of over two million dollars.

DEFINITION OF ADVERTISING

At the outset of any discussion concerning advertising, it will be a simple matter to identify those practices which would be subject to less than 100 percent deductibility. However, over a period of time I suggest that much of the advertising activities of a business would fall into grey areas in which precise definitions would be difficult if not impossible. For example, would the salary of a marketing director be divided between advertising and non advertising activities, some fully deductible and the rest only partially so? Would the handbill left by a neighborhood salesperson regretting the fact no one was home when he/she stopped by be an advertisement or some other marketing tool? Would "enhanced underwriting" of public broadcasting programming become, by IRS regulation, advertising and therefore less than fully deductible? Inaccurate definitions, arbitrary regulations and unworkable concepts create complexity, which seems contrary to the efforts of this Committee when it took the lead to simplify and overhaul our tax code in the last Congress.

FOOT IN THE DOOR AND THE SLIPPERY SLOPE

While I am clearly opposed to any change in the deductibility of advertising costs, I am fully aware of the task that confronts this Committee and the Congress generally. Deficit reduction is a problem that has few solutions, all of them difficult. Awareness of that fact makes it abundantly clear that current proposals to defer or amortize advertising costs only postpone the inevitable. With trillion dollar deficits, proposals that raise $10.8 billion or more will not suddenly sunset. Congress will act, if not now then in the future, to make permanent the revenue gained by the federal treasury from these measures.

Just as clear is the assumption that a smaller reduction in deductibility perhaps 10 percent rather than 20 percent would be less harmful. If my prior concern of the loss of deductibility becoming permanent is the "foot in the door," then this concern is the "slippery slope." By treating advertising differently from other legitimate business expenses, even if initially done in small increments, we have proceeded down the slope, absent any justifiable tax policy rationale, to reduce the marketplace role advertising plays. It is our sincere hope that the Committee rejects this proposal.

TOBACCO AND ALCOHOL

I have commented on the proposals in the Joint Tax Committee print which speak to the more general deductibility proposals. I would now like to draw your attention to the proposals included in the print relating to the deductibility for advertising and promotion of tobacco or alcohol.

The National Association of Broadcasters opposes both proposals. Many of the objections I have raised concerning the broader deductibility proposals are equally applicable here. Clearly the treatment of advertising would be much different from other intangible costs that would still be fully deductible. Particulary with respect to the advertising of alcohol products (beer and wine), there would be a severe financial impact on radio and television broadcasters.

Loss of deductibility for these product categories would set a precedent for similar actions in other product categories that raise health or social policy concerns: e.g., eggs, pork, sugar, off-road vehicles, over-the-counter pharmaceutical products and beef.

In the area of tobacco product advertising and promotion, this nation's broadcasters are prohibited by law from advertising any tobacco product, save pipe tobacco and cigars. These prohibitions enacted in several steps over the past 20 years were taken because of the deep and convincing body of science which shows tobacco consumption to be per se harmful. The use of warning labels and other disclaimers have had some impact on consumption. Essentially, all that the government can do to steer its citizens away from tobacco has been done. If the government wishes to do more, the next step is to declare the product illegal and all advertising would cease.

The Committee also is confronted with a proposal to ban all advertising and promotion of alcohol products, which on radio and television is voluntarily limited to beer and wine. We are well aware of the concerns raised by the abuse or misuse of alcohol products. Broadcasters nationally and locally have been leaders in alerting the public to the dangers of abuse. This is the critical difference between the two products: consumption of tobacco is per se harmful; it is the abuse or misuse of beer and wine which creates societal concern.

Let me add that the issue of beer and wine advertising had full and extensive hearings in the 99th Congress in both the House and Senate. Despite lobbying by groups concerned about this subject and heavy "grass roots" pressure, both houses declined the invitation to act. To the contrary, members of the House and Senate familiar with this issue felt that new laws or restrictions on the advertising of beer and wine were unnecessary to inform and educate the public as to the dangers of abuse or misuse of these products.

In closing, Mr. Chairman, I am sure there are those who see advertising as an unnecessary or perhaps extravagant expenditure, thereby justifying different and burdensome tax treatment. However, the advertising of goods and services is inextricably linked to the sale of these same goods and services. Reduction of one will do harm to the other and the effect will be felt throughout the economy.

The harm to broadcasting will be exceptionally sever. In the minds of many, broadcasting is synonymous with the three major television networks. Broadcasting is in reality thousands of local radio and television stations. Changes in the tax treatment of advertising will be felt at these stations, and the local communities these stations serve will be the real losers.

Thank you.

Mr. Fritts. We appreciate very much the cooperation we have received from you and your staff, Mr. Chairman, in making it possible for us to discuss with you proposals to eliminate business deductions for advertising expenses.

The notion of raising revenues by limiting the deductibility of advertising echoes a similar proposal raised in the last Congress during this committee's consideration of tax reform legislation. The views I will express are consistent with the concerns of a broad coalition of media and advertising interests, some of whom are represented right behind me here.

As sellers, buyers and providers of advertising time and/or space, we oppose any attempt to reduce the deductibility of advertising expenses.

Although limiting the deductibility of advertising is universally opposed by media and advertising representatives, such a measure would be especially damaging to broadcasting. Commercial over the year broadcasting is supported solely by the sale of advertising time. Unlike most of our competitors, such as newspapers, magazines, cable television systems, broadcasting has no subscription base. Any action which creates a disincentive to advertise will be felt immediately by the thousands of local radio and television outlets across our country.

The proposal to reduce the deductibility of advertising is based on the suggestion that some benefit of advertising carries past the year in which it is expensed. The overwhelming volume of advertising is designed to alert the consumer to the availability of a certain product perhaps at a certain location and a certain price. The ability to take advantage of a July 4th sale, for instance, for a new automobile, or the price of a pound of peaches in August will do the consumer no good the following February.

There is no hesitation on my part to remind this committee that advertising is an ordinary and necessary business expense geared to maximizing the sale of goods and services.

A business expense in job training, research and development, public relations and advertising all lead to the same business goal, that is, the sale of products, which generates profits and taxes.

Should you suggest that the useful life formula be applied to advertising, why should not the same formula then be applied to research and development, public relations or job training, the effects of which are much more likely to extend beyond the year of expense than would advertising?

No less dangerous is the assumption that a smaller reduction in deductibility, perhaps 10 percent rather than 20 percent, would be less harmful. Treating advertising differently from other legitimate business expenses, even if initially in small increments, separates advertising from other legitimate business expenses, and that separation discriminates against a vital segment of the economic chain.

We also oppose the elimination of tax deductibility for cost of advertising or promoting tobacco and alcohol products.

Many of the objections I have raised concerning the broader deductibility proposals are equally applicable here. In the area of tobacco product advertising and promotion, this nation's broadcasters are prohibited by law from advertising any tobacco product, save pipe tobacco and cigars.

The use of warning labels and other disclaimers have had some impact on consumption. Essentially, all the government can do to stir its citizens away from tobacco has and is being done.

If the government wishes to do more than the next logical step, we would suggest would be to declare the product illegal.

The committee may also be confronted with proposals to ban all advertising and promotion of alcohol products which, on radio and television, is voluntarily limited to beer and wine.

We are well aware of the concerns raised by the abuse and misuse of alcohol products. Broadcasters nationally and locally have been leaders in alerting the public to dangers of abuse through our many public service campaigns.

After extensive hearings in the last Congress, members of the House and Senate familiar with this issue felt that new laws or restrictions on advertising of beer and wine were not necessary to inform or educate the public as to the dangers of the misuse or abuse of these products.

In conclusion, broadcasting, in reality, is thousands of local radio and television stations each paying their fair share of local taxes. Changing in the tax treatment of advertising will be felt at these stations and the local communities which these stations serve. These communities, obviously, would be the loser.

I thank you for your time and your consideration.

The CHAIRMAN. Thank you.

Mr. True.

STATEMENT OF S.M. TRUE, JR., PRESIDENT, TEXAS FARM BUREAU, TESTIFYING ON BEHALF OF THE AMERICAN FARM BUREAU FEDERATION, PLAINVIEW, TX

Mr. TRUE. Thank you, Mr. Chairman.

My name is S.M. True and I am a farmer from Plainview, Texas where I raise cotton, grain sorghum, wheat and soybeans. I also serve as President of the Texas Farm Bureau and am a member of the Board of Directors of the American Farm Bureau Federation. And I am pleased to appear before the committee today to present the Farm Bureau's testimony on tax increase options which are under consideration by the committee.

The American Farm Bureau Federation is the nation's largest general farm organization with more than 3.5 million member families in 2,800 county farm bureaus throughout the [illegible]9 States and Puerto Rico. Farm Bureau membership includes over three-fourths of the commercial farmers and ranchers in the country.

During the development of House Concurrent Resolution 93, the fiscal year 1988 budget resolution, the budget committees were advised that Farm Bureau members do not support tax increases to balance the budget. Rather, we suggest an alternative of across-the-board spending cuts in all areas of government programs, including Defense, entitlements and agriculture to meet the deficit targets of Gramm-Rudman-Hollings.

As you know, Congress rejected this approach and, instead, approved a federal budget which calls for the enactment of almost $65 billion in tax increases over a 3-year period: $19.3 billion in 1988; $22 billion in 1989; and $23 billion in 1990.

The House Ways and Means Committee and the Senate Finance Committee are charged with the responsibility of drafting tax changes to achieve higher taxes required in budget reconciliation. Among the tax increase options are several that affect farmers and ranchers and we appreciate the opportunity to comment on these proposals.

Estate taxes. Farm Bureau members were active in estate tax reform back in 1976 and again in 1981 when Congress enacted the Economic Recovery Tax Act that provided significant estate tax relief for farm families. Several of the revenue raising options before the committee would wipe out the estate tax reform achieved in the last decade.

As an example, a reduction in the credit that exempts $600,000 of an estate's value from taxation would hurt farm families. Although land values have falled in the past few years, they have now stabilized at prices that continue to reflect previously inflated gains that are unrelated to the productivity productive value of the land.

Inflated gains cause higher estate valuations and, therefore, higher taxes that may force the sale of family farms to pay the taxes on the property.

A capital gains tax at death, or the imposition of a carryover basis, would also tax inflationary gains unrelated to the productive capacity of the property.

Farm and ranch heirs should not be forced to pay increased taxes on an artificial gain in land values, especially when the appreciation occurred prior to their ownership.

The following example shows the burden of either capital gains taxation at death or carryover basis.

Assume the decedent's original cost of an acre of land is $500.00 and is worth $1500.00 at death. An heir sells the acre for $1800.00. Under current law, taxable gain to the heir is $300.00, $1800.00 minus the $1500.00. Under the tax increase proposal in which the original cost basis is carried over to calculate the gain, the taxable gain is $1300.00, much of which is due to inflation, $1800.00 minus the $500.00.

Disregarding carryover basis, a capital gains tax at death would automatically tax the difference between the decedent's purchase price and its value at death, even though the property is not sold.

In addition to higher tax bills, these tax increase options present an administrative burden to fiduciaries, cause valuation problems and liquidity problems, and raise the possibility of double taxation through the aggregate effect of estate and capital gains taxes. Moreover, all capital gains are now taxed at ordinary rates which means even higher taxes.

Excise taxes. Various proposals have been recommended to raise the excise taxes on tobacco and alcohol. Excise taxes on tobacco and alcohol have already been increased in recent years. Higher excise taxes have an adverse trickle down effect on the farmers whose commodities such as tobacco, grains and wine grapes go into tobacco and alcohol products. The same argument can be made for farmers whose grain goes into ethanol production and whose market could be damaged if the ethanol exemption is repealed.

Higher taxes would lessen the demand for these products and cause reduced marketing opportunities.

The CHAIRMAN. Mr. True, I will have to ask you to summarize.

Mr. TRUE. Thank you, Mr. Chairman, for the opportunity to be here.

The CHAIRMAN. Thank you.

Mr. Supica, we are very pleased to have you.

[The prepared written statement of Mr. True follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SENATE FINANCE COMMITTEE REGARDING TAX INCREASE OPTIONS

JULY 16, 1987

Presented by S. M. True
President, Texas Farm Bureau Federation
and
Member, Board of Directors of the American Farm Bureau Federation

My name is S. M. True and I am a farmer from Plainview, Texas, where I raise cotton, grain sorghum, wheat and soybeans. I am President of the Texas Farm Bureau Federation and a member of the Board of Directors of the American Farm Bureau Federation. I am pleased to appear before the Committee today to present Farm Bureau's testimony on tax increase options which are under consideration by the Committee.

The American Farm Bureau Federation is the nation's largest general farm organization with more than 3.5 million member families in 2,800 County Farm Bureaus throughout 49 states and Puerto Rico. Farm Bureau membership includes over three-fourths of the commercial farmers and ranchers in the country.

During the development of H. Con. Res. 93, the FY 1988 budget resolution, the budget committees were advised that Farm Bureau members do not support tax increases to balance the budget. Rather, we suggested an alternative of across-the-board spending cuts in all areas of government programs including defense, entitlements, and agriculture to meet the deficit targets of Gramm-Rudman-Hollings. As you know, Congress rejected this approach and instead approved a federal budget which calls for the enactment of almost $65 billion in tax increases over a three year period ($19.3 billion in 1988, $22 billion in 1989, and $23 billion in 1990).

The House Ways and Means Committee and the Senate Finance Committee are charged with the responsibility of drafting tax changes to achieve higher taxes required in budget reconciliation. Among the tax increase options are several that affect farmers and ranchers, and we appreciate the opportunity to comment on these proposals.

ESTATE TAXES

Farm Bureau members were active in estate tax reform in 1976 and again in 1981 when Congress enacted the Economic Recovery Tax Act that provided significant estate tax relief for farm families. Several of the revenue raising options before the Committee would wipe out the estate tax reform achieved in the last decade. For example, a reduction in the credit that exempts $600,000 of an estate's value from taxation would hurt farm families. Although land values have fallen in the past few years, they have now stabilized at prices that continue to reflect previously inflated gains that are unrelated to the productive value of the land. Inflated gains cause higher estate valuations and therefore higher taxes that may force the sale of family farms to pay the taxes on the property.

A capital gains tax at death, or the imposition of carryover basis, would also tax inflationary gains unrelated to the productive capacity of the property. Farm and ranch heirs should not be forced to pay increased taxes on an artificial gain in land values, especially when the appreciation occurred prior to their ownership. The following example shows the burden of either capital gains taxation at death or carryover basis. Assume the decedent's original cost of an acre of land is $500 and worth $1500 at death. An heir sells the acre for $1800. Under current law, taxable gain to the heir is $300 ($1800 minus $1500). Under the tax increase proposal in which the original cost basis is "carried over" to calculate the gain, the taxable gain is $1300, much of which is due to inflation ($1800 minus $500). Disregarding carryover basis, a capital gains tax at death would automatically tax the difference between the decedent's purchase price and its value at death even though the property is not sold. In addition to higher tax bills, these tax increase options present an administrative burden to fiduciaries, cause valuation problems and liquidity problems, and raise the possibility of double taxation through the aggregate effect of estate and capital gains taxes. Moreover, all capital gains are now taxed at ordinary rates which mean even higher taxes.

EXCISE TAXES

Various proposals have been recommended to raise the excise taxes on tobacco and alcohol. Excise taxes on tobacco and alcohol have already been increased in recent years. Higher excise taxes have an adverse trickle down effect on the farmers whose commodities such as tobacco, grains, and wine grapes, go into tobacco and alcohol products. The same argument can be made for farmers whose grain goes into ethanol production and whose market could be damaged if the ethanol exemption is repealed. Higher taxes will lessen the demand for these products and cause reduced marketing opportunities.

GENERAL COMMENTS

We understand that Congressional tax writers are attempting to spread the pain of tax increases by balancing the regressive nature of excise taxes with the progressive nature of estate taxes. However, a major consideration is not understood: Farmers and ranchers are part of an income group caught in the middle and will therefore be hit by all kinds of tax increase proposals. In particular, we urge you to reject increases related to estate taxation and excise taxes.

While we acknowledge the reconciliation requirements of the budget resolution, we ask the Committee to be mindful of the detrimental effects of higher gasoline taxes and an oil import fee; of the damage that could be done to the tax reforms of 1986 by a freeze or increase in income tax rates; of the effects of excise tax hikes on certain sectors of agriculture; and of the problems that the carryover basis, capital gains at death, and a reduction in the unified credit cause for farm families whose family and business assets are affected by these provisions and whose property could have to be sold to pay the taxes.

We recognize the enormous task that the Committee faces and hope that our comments have been useful to you.

Thank you for the opportunity to testify.

STATEMENT OF JAMES W. SUPICA, PRESIDENT, UNITED CONSTRUCTION CO., INC., LENEXA, KANSAS, TESTIFYING ON BEHALF OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. SUPICA. Thank you, Mr. Chairman. My name is Jim Supica. I am a general contractor from Lenexa, Kansas. I am here today representing the Associated General Contractors of America. AGC represents more than 32,000 firms including 8,000 of America's leading general contracting construction firms.

These contractors perform over 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities, and employ more than three and a half million individuals. We certainly appreciate this opportunity, Mr. Chairman, to testify on revenue-raising options for deficit reduction now before this committee.

Three major revisions of the Tax Code have already been enacted by Congress since 1980. The construction industry is still attempting to adjust to the sweeping tax changes enacted just last year which have impacted every aspect of our business, including our public and private construction markets.

A study of the 1986 tax law by CIT and Peat Marwick recently found that the 9,300 heavy construction contractors in the study were the hardest hit of any industry, with a 151 percent increase in 1987 tax liability over 1986. Just a few months later, 200 revenue-raising options are now before this committee for consideration and many of them would once again seriously impact the construction industry.

Due to time limitations, I will focus on only a few of our concerns, but I would like to point out one common thread. As an industry that embodies the most competitive free market ideals, we urge you, Mr. Chairman, to reject proposals offered in the name of revenue-raising which, in fact, will generate more paperwork than revenue, and which will limit the ability of the construction industry to properly contribute to our nation's economic well-being.

One revenue-raising option being considered is to require 100 percent of all long-term contracts—that is other than contracts of small businesses exempted under the present law—to be reported under the percentage of completion method of accounting. This would be done either by requiring all contracts entered into after the end of 1987 to use PCM, or by increasing the use of PCM so that 200 percent of contracts would be covered by 1989. Both of these options would totally eliminate the completed contract method of accounting for firms with more than $10 million in annual revenues.

AGC strongly urges this committee to reject this revenue-raising option. Most firms in the construction industry are in the midst of a very painful transition from the completed contract method of accounting, used by the industry from its inception since 1918, to the 60-40 method devised by the Joint Committee on Taxation last September.

This 60-40 method was applied retroactively and no provision was made to ease the switch in accounting method, such as a 4-year adjustment period. As a result, construction contractors with shorter long-term contracts are making the entire transition in just one or two years. This is having a very serious financial impact on our firms, as most of us are thinly capitalized and must borrow to pay sizeable tax bills.

Each of the two accounting methods now available to construction contractors, the new 60-40 method and percentage of completion, are extremely complex and difficult to administer. The most significant paperwork problem facing contractors is the new lookback method, which applies to PCM under both methods. While the goal of the lookback method, correcting estimation errors, is admirable, many serious problems remain in applying the method of construction.

AGC respectfully urges Congress to reject the revenue-raising options currently under consideration to eliminate the remaining use of the completed contract method of accounting.

AGC also strongly opposes increasing, for deficit reduction purposes, the federal user fees which support this nation's Highway Trust Fund and our nation's Airport and Airway Trust Fund.

AGC believes that any increase in transportation user fees must be used for the sole purpose of preserving and enhancing the transportation infrastructure which is so vital and underpins our nation's economy.

Especially now—at a time when the federal-aid highway program has been reauthorized at levels insufficient to meet our nation's pressing highway and bridge needs, thereby placing an even heavier burden on our State and local governments to fill that void—AGC believes it would be wholly inappropriate for Congress to add to that burden by preempting, for non-transportation purposes, the primary source of revenue that States and localities must now rely upon to fund much-needed highway improvements.

In fact, increasing federal motor fuels taxes would not just preempt States from raising additional revenues for highway improvements, it would also undermine their efforts by significantly reducing currently available revenues.

The National Association of State Budget Officers projects that diminished fuel consumption resulting from a 12 cent federal motor fuels tax increase would not only create a $3.4 billion shortfall in federal Highway Trust Fund revenues over the next five years, it would also cause an additional $4 billion to be irrevocably lost to State treasuries over the same period.

The CHAIRMAN. If you would summarize, please, your final comments.

Mr. SUPICA. Yes, sir, I certainly will.

With regard to an oil import fee, contractors must assess, and price accordingly, the costs of demand and supply situations when we submit bids on public works projects through the open competitive bidding system. AGC believes that contractors should not be penalized by action of their own government after these contract awards by imposing an oil import fee unless there is a provision, sir, that would permit our contractors to have an adjustment period to adjust to those increased taxes.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Supica, for your comments.

[The prepared written statement of Mr. Supica follows:]

Testimony of

James W. Supica

for

The Associated General Contractors of America

Presented to

The Committee on Finance

United States Senate

on the Topic of

Revenue - Raising Options

for Deficit Reduction

July 16, 1987

Thank you, Mr. Chairman.

My name is James W. Supica and I am here today representing the Associated General Contractors of America. AGC represents more than 32,500 firms, including 8,400 of America's leading general contracting construction firms. These contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial, and municipal-utility facilities, and employ more than 3,400,000 individuals. I appreciate the opportunity to testify on revenue-raising options for deficit reduction now before the Committee.

Three major revisions to the tax code have already been enacted by Congress in the 1980s. The construction industry is still attempting to adjust to the sweeping tax changes enacted just last year, which have impacted every aspect of our business, including our public and private construction markets. A study of the 1986 tax law by the CIT Group and Peat Marwick recently found that the 9,300 heavy construction contractors in the study were the hardest hit of any industry, with a 151.5 percent increase in 1987 tax liability over 1986. Just a few months later two hundred revenue-raising options are now before this Committee for consideration, and many of them would once again seriously impact the construction industry.

Due to time limitations, I will focus on only a few of our concerns, but I would like to point out one common thread. As an industry that embodies the most competitive free market ideals, we urge you to reject proposals offered in the name of revenue-raising which in fact will generate more paperwork than revenue, and which will limit the ability of the construction industry to properly contribute to our nation's economic well-being.

AGC Opposes Requiring the Percentage of Completion Method of Accounting

One revenue-raising option being considered is to require 100 percent of all long-term contracts (other than contracts of small businesses exempted under present law) to be reported under the percentage of completion method (PCM) of accounting. This would be done by either requiring all contracts entered into after the end of 1987 to use PCM, or by increasing the use of PCM so that 100 percent of contracts would be covered by 1989. Both of these options would totally eliminate the completed contract method of accounting for firms with more than $10 million in annual revenues.

AGC strongly urges the Committee to reject this revenue-raising option. Most firms in the construction industry are in the midst of a very painful transition from the completed contract method of accounting, used by the industry from its inception in 1918, to the 60-40 method devised by the Joint Committee on Taxation last September.

This 60-40 method was applied retroactively and no provision was made to ease the switch in accounting method, such as a four-year adjustment period. As a result, construction contractors with shorter long-term contracts are making the entire transition in just one or two years. This is having a very serious financial impact on these firms, as most are thinly capitalized and must borrow to pay sizeable tax bills.

Each of the two accounting methods now available to construction contractors, the new 60-40 method and percentage of completion, are extremely complex and difficult to administer. The most significant paperwork problem facing contractors is the new lookback method which applies to PCM under both methods. While the goal of the lookback method, correcting estimation errors, is admirable, many serious problems remain in applying the method in construction.

The problems, which at times seem insurmountable to the construction industry, include integrating the lookback rule with the new alternative minimum tax and the correct treatment of contract disputes and lawsuits. Some AGC contractors have over 750 contracts. After a contract's completion the lookback rule requires contractors to recalculate each year's taxes, compute under or overpayments, and calculate interest owed to or by the government. All of these calculations must be done on a contract by contract basis. We are talking about thousands and thousands of calculations.

With so many unresolved issues, and no regulatory guidance yet on the problems associated with the lookback rule, AGC urges Congress to reject the revenue-raising option currently under consideration of eliminating the remaining use of the completed contract method of accounting.

AGC Opposes Increasing Transportation User Fees for Deficit Reduction

AGC also strongly opposes increasing, for deficit reduction purposes, the federal user fees which support the Highway Trust Fund and the Airport and Airway Trust Fund.

AGC believes that any increase in these transportation user fees must be used for the sole purpose of preserving and enhancing the transportation infrastructure which underpins our nation's economy.

Especially now -- at a time when the Federal-aid highway program has been reauthorized at levels insufficient to meet our nation's pressing highway and bridge repair needs, thereby placing a heavy burden on state and local governments to fill this void -- AGC believes it would be wholly inappropriate for Congress to add to that burden by preempting, for non-transportation purposes, the primary source of revenue that states and localities must rely upon to fund much-needed highway improvements.

In fact, increasing federal motor fuels taxes would not just preempt states from raising additional revenues for highway improvements; it would also undermine their efforts by significantly reducing currently available revenues. The National Association of State Budget Officers projects that diminished fuel consumption resulting from a 12 cent federal motor fuels tax increase would not only create a $3.4 billion shortfall in federal Highway Trust Fund revenues over the next five years, it would also cause an additional $4 billion to be irrevocably lost to state treasuries over the same period.

Moreover, AGC believes the dedicated, user-fee financed federal transportation trust funds, and the vital infrastructure construction programs they support, have already been called upon to do more than their "fair share" toward deficit reduction. By limiting highway and airport improvement program expenditures below levels which these transportation trust funds can support, Congress and the Administration have already allowed the cash balances in these dedicated funds to collectively balloon to almost $20 billion, just to make the federal deficit appear less serious than it really is.

In summary, AGC believes Congress must reject the temptation to reduce the general fund deficit by increasing dedicated transportation trust fund user fees, which are so obviously needed to support the vital transportation infrastructure programs so critically important to America's economy and global competitiveness.

Equitably Treating Construction Contractors Engaged in Long-Term Fixed Price Contracts Under an Oil Import Fee

A per-barrel fee on imported and/or domestic crude oil and refined petroleum products has also been suggested as an option for increasing federal revenues for deficit reduction.

The construction industry, which is a major consumer of petroleum-based products, is an industry based on open, competitive bidding and long-term, fixed-price contracts. These fixed-price contracts may take two, three or four or more years to complete. Once the low bid is accepted and the contract is awarded, a contractor is committed to accomplishing the contract at the firm bid price. The contractor does not have the opportunity, like firms in other industries, to increase the contract price to reflect increases in the cost of materials or fuel. Contractors who have bid for work prior to an import fee on crude oil could stand to lose millions of dollars due to the price increase in fuel and petroleum-based products that would occur with the imposition of oil import fees.

While contractors must assess, and price accordingly, the costs of demand and supply situations before winning contracts through open competitive bidding, AGC believes they should not be penalized by actions of their own government after contract award.

Accordingly, AGC believes that should Congress impose a per-barrel fee on imported and/or domestic crude oil, provisions must also be established to rebate to the contractor the increased costs in hydrocarbons and their derivative products on fixed-price or guaranteed-maximum price construction contracts bid on or entered into prior to the implementation of the government program which results in the increased prices.

The CHAIRMAN. Mr. True, your comments on the repeal of the stepped-up basis or returning to the carryover basis on estates. I have seen some comments that this constitutes a loophole. I think that is an outrageous characterization.

First, I do not look on death as a voluntary conversion. And here is what you are talking about, an income tax on income that has never been received; that tax, then an estate tax on top of that. You are talking about a double tax. That is what you are really talking about. And that means that in many instances you would have an absolutely prohibitive estate tax when the two are put together, and that would force liquidation of farms and ranches. Then you run into a nightmare of trying to find out what the cost was. Sometimes these farms and ranches have been in the family for generations. And the person that knows the information best is deceased. You would have a serious problem for banks' trust departments, officers, lawyers and the Treasury trying to arrive at that figure.

So I share very much your view there. We fought that fight; we have been through that fight before, and Congress resoundly rejected it.

Mr. TRUE. Senator Bentsen, the estate tax creates a situation where people don't even want to die.

[Laughter.]

The CHAIRMAN. I tell you. I think that might be a little bit of an understatement. But I agree, it is not a voluntary conversion for most people. So I share your concern.

Mr. Supica, I understand some of the complexities that were added by the tax reform law in trying to arrive at more equity and more fairness in taxes. But this is not the debate at this point, and I do not see us reopening that in any major way this year. Some of those things will, I am sure, be addressed in the future. I have no further questions. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Fritts, I would like to ask you about alcohol advertising currently on TV and radio. Did I understand you to say that that is an abstention that the networks or the stations currently carry forward voluntarily? Is that it?

Mr. FRITTS. Currently, broadcasters do not broadcast advertisements for hard liquor and that is a voluntary restraint.

Senator CHAFEE. That is not prohibited by the Federal Communications Commission?

Mr. FRITTS. No, it is not.

Senator CHAFEE. Oh, I did not know that. So if some station wanted to do it they are free to do it?

Mr. FRITTS. They are free to do it. But those who have done it, in most cases, have decided that it was not in their best interest to do so.

Senator CHAFEE. I see. All right.

Mr. True, I had a couple of questions. First of all, I come from a State there is not all that much farming in. And I regret to say, I suspect I notice the Farm Bureaus in 49 States, I just wonder whether we are not the guilty State that does not have a ranch or a farm.

Mr. TRUE. No, sir, you are not.

Senator **Chafee**. We are not. All right. Well that is refreshing to hear.

Now what is sorghum wheat?

Mr. **True**. Sorghum grain, it is a milo-type grain. It has pretty much the same feeding value as corn.

Senator **Chafee**. How do you get a situation where the land values are prices that are higher than the productive value of the land?

Mr. **True**. That is very true today, sir.

Senator **Chafee**. I know we had it before because there was a speculative atmosphere that the land is constantly going to become more and more valuable. But then we went through the recession, if you would, and the dramatic decrease in the price of land. Now you are saying it is coming back and the same thing is reoccurring as took place before?

Mr. **True**. Yes, sir. I don't want to call it "speculative value." I said the appraised value of land today in many areas is much greater than the productive value of that land. Take wheat land, or I don't know what you are familiar with in your part of the country.

Senator **Chafee**. Well, potato land.

Mr. **True**. Potatoes is a pretty high cost productive item. It cost a lot of money to raise potatoes. And in many areas there is a very small percentage of profit. In my county, there was absolutely no profit in the raising of potatoes the year before last. Many acres were plowed up. So the productive value of that land was zero at that particular time. And over a period of years, many of the crops that we are doing today—wheat, for instance—the price of wheat as low as it is, it takes many, many years just to generate 800 or a thousand dollars that that land is based on—the value of that land today for tax purposes and whatnot.

Senator **Chafee**. Where I come from, the price of the land is driven up by other factors than farming value, as obviously development for residential purposes and so forth. But where you come from, out in your area, I suppose if the land is not used for farming or crop growing, it lies fallow. I mean it isn't that some residential development is going to come there.

Mr. **True**. No, sir. We have that residential development in Texas and even out in the area that I live in also. But there is very little land that lays fallow in my particular area. It is all intensively cultivated. We raise cotton or wheat or grain sorghum or vegetables. It is an intensive agricultural State.

Senator **Chafee**. I have no other questions.

I want to thank everybody from the panel for coming here. You have come from considerable distances some of you and we thank you very much. And that concludes the hearing.

[Whereupon, at 12:35 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

DUKE UNIVERSITY
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July 9, 1987

Laura Wilcox
Senate Finance Committee
Room 205
Dirksen Senate Office Building
Washington, DC 20510

Dear Ms. Wilcox,

I understand that the Senate Finance Committee is holding hearings on options for raising federal revenues, scheduled for next week. I would like to request that this letter and the enclosed article be included in the official record of these hearings.

I am an economist, and have done extensive empirical research on the economics of alcohol abuse with particular focus on the liquor excise tax. Three conclusions have emerged from my research that are particularly relevant to the hearings: 1. There has been a substantial long term decline in the prices of alcoholic beverages relative to the prices of other goods and services. In part this decline is the result of the failure of the federal excises to increase with general inflation; 2. Increasing the price of liquor and other alcoholic beverages will save lives by reducing the cirrhosis mortality rate and the highway fatality rate; and 3. The alcohol excise tax is concentrated on the relatively small proportion of the population that drink heavily, which is of course the group that generates the bulk of alcohol related social costs. In that sense, this tax could be considered "fair."

Each of these points is developed in the enclosed article, "Increasing the Federal Alcohol Excise Tax," which was published in a National Academy Press book titled **Toward the Prevention of Alcohol Problems** (Dean R. Gerstein, editor).

I appreciate the opportunity to participate in the debate over this important issue.

Sincerely,
Philip J Cook
Philip J. Cook

PJC/bw
Enclosures

Toward the Prevention of Alcohol Problems

Government, Business, and Community Action

Dean R. Gerstein, *editor*

Summary of a conference held under
the auspices of the

Panel on Alternative Policies
Affecting the Prevention of Alcohol Abuse and Alcoholism

Commission on Behavioral and Social Sciences and Education

National Research Council

NATIONAL ACADEMY PRESS
Washington, D.C. 1984

3 Taxing and Spending

INCREASING THE FEDERAL ALCOHOL EXCISE TAX

PHILIP J. COOK, Duke University

Inflation and the Erosion of the Excise Tax

The prices of alcoholic beverages have been declining rapidly in recent years in comparison with prices of other consumer items. Consumer price index statistics indicate that since 1967 the real price of all alcoholic beverages has declined 27 percent. Distilled spirits have led the way with a 48 percent fall in price, followed by beer (25 percent) and wine (19 percent). The results of econometric and epidemiologic studies show that such reductions in relative price have the effect of promoting alcohol consumption and increasing the incidence of alcohol-related problems.

The fact that liquor prices are currently at about one-half of the 1967 level can be attributed in part to congressional inaction with respect to federal excise taxes on alcoholic beverages. Current federal excise tax rates were set in 1951 but have been largely repealed by inflation since then. If the federal tax had been indexed to the consumer price index in 1967, the cost of a fifth of liquor would currently be about $3.50 higher. Indexing the beer tax would have had a smaller but still substantial effect on beer prices. It can be argued that the failure of Congress to increase taxes in step with inflation constitutes the most important feature of federal government policy in alcohol abuse prevention during the past 15 years.

The recent wave of concern over mounting federal deficits has put the federal alcohol tax back on the national political agenda. There is an obvious parallel with the federal cigarette tax, which had also been left at its Korean War level—$.08 per pack—for 30 years and then was doubled by Congress in 1982. While the impetus for raising this tax was a concern with "revenue enhancement," the more important consequence will be to promote the public health by reducing smoking. Similarly, an important consequence of an increase in the alcohol tax would be to reduce alcohol abuse and its attendant personal and social costs. I summarize here the evidence on the preventive effects of alcohol taxes and then discuss the distributional and revenue impacts of a tax increase.

Alcohol Taxes and the Rate of Alcohol Abuse

Alcohol abuse is a major public health problem. There are roughly 75,000 alcohol-related deaths each year (Gerstein, 1981:205). Chronic heavy drinking is responsible for a large fraction of the more than 27,000 deaths each year due to liver cirrhosis as well as about 5,000 deaths classified as resulting from "alcoholism." The remaining alcohol-related deaths involve failures in judgment, attention, and physical coordination resulting from inebriation, including about 25,000 alcohol-related auto fatalities and a number of other accidents, homicides, and suicides. Alcohol-related morbidity and injuries impose a considerable burden on the health care system. A recent estimate (Schifrin, 1983) of health care costs stemming from alcohol-related problems is $20 billion for 1979—about 10 percent of total health care expenditures for that year. The cost of absenteeism and reduced productivity associated with employee drinking and premature death is even greater—roughly $78 billion in 1979 (Schifrin, 1983).

For alcohol taxes to be an effective policy instrument for reducing these and other costs associated with alcohol abuse, it must be true that higher alcohol prices reduce the prevalence of chronic heavy drinking and the incidence of drunkenness. An increase in taxes on liquor, wine, or beer results in an increase in the average prices of these commodities and a reduction in alcohol consumption from these sources. (More precisely, consumption is less than it would have been without the tax increase.) This result has been established quite conclusively for data from the United States and Canada (Johnson and Okanen, 1977; Ornstein and Hanssens, 1981; Cook and Tauchen, 1982). More important and controversial is the question of how taxes and prices influence the consumption levels of the heaviest drinkers. It is logically possible that average consumption would fall as a result of a tax increase solely due to its effect on moderate drinkers; the heaviest drinkers are immune to economic incentives. An argument supporting this possibility can be stated by a chain of propositions: (1) a large portion of the heaviest drinkers are alcoholics, in the sense that they are addicted to alcohol; (2) alcohol addicts will drink something like the biological maximum every day, practically regardless of the cost of obtaining their drinks; (3) therefore, it must be the more moderate drinkers who adapt their drinking practices to the price of alcoholic beverages.

This sort of argument may seem plausible to many. In reply, an economist would point out that a price increase has a greater economic impact on an alcoholic—who may already be spending a third or more of his or her income on alcohol—than on a moderate drinker, and that ordinarily this greater impact would be expected to yield, if anything, a greater response in consumption behavior. Furthermore, there is considerable clinical evidence that alcohol consumption by alcoholics is responsive to experimental manipulations of the costs of taking a drink (Mello, 1972; Nathan and Lisman, 1976). In any event, this issue can be better resolved through careful empirical analysis than through unsupported generalizations about the behavior in question.

The Effect of Alcohol Taxes on Cirrhosis Mortality Statistics on the prevalence of chronic heavy drinking are not widely available. However, there is a widely accepted proxy measure—the rate of deaths due to cirrhosis of the liver. These death rates have provided the basis for nearly all estimates of alcoholism prevalence rates (Seeley, 1960).

Most people who die of liver cirrhosis, especially after age 30, exhibit a history of chronic intense drinking: Schmidt (1977) found that 80 percent of all cirrhosis deaths in Ontario in 1974 were alcohol-related. The typical victim of alcohol-related cirrhosis has consumed an enormous amount of alcohol; Lelbach (1974) estimates that a primarily healthy, 150-pound person who drinks roughly 21 ounces of 86 proof liquor every day for about 20 years has a 50 percent chance of contracting liver cirrhosis. Thus, for any one individual, there tends to be a long lag between the onset of heavy drinking and the prospect of death from liver cirrhosis. The cirrhosis mortality rate is therefore not a direct indicator of the current fraction of alcoholics in a population, but does give a good indication of the fraction that has been drinking heavily for two or more decades. It should be kept in mind that the cirrhosis mortality rate is of interest in its own right, in addition to being a proxy for the prevalence of alcoholism. Cirrhosis is among the leading causes of death in the United States, Canada, and most European nations.

Using this statistical indicator of the prevalence of chronic excess consumption, it is possible to explore the relationship between alcohol taxes and excess drinking. My first study of this relationship (Cook, 1981) was based on annual observations of 30 states for the 15-year period spanning 1960 to 1974. During this period there were 38 instances in which one of these states increased its liquor tax by a substantial amount (more than $.24 per proof gallon). I viewed each of these tax increases as a test case in a sort of "natural experiment." For each of these test cases, the percentage change in the state's cirrhosis mortality rate was calculated; the test statistic was defined as the mortality rate during the 3 years before the tax increase. The control groups for each of these test cases were the other states in the corresponding years. The result was that states that raised their liquor tax typically had a greater reduction (or smaller increase) in cirrhosis mortality than other states in the corresponding year (see Table 3-1). Indeed, 63 percent of all test cases were in the upper half of the distribution with respect to the test statistic—a result that would occur by chance alone with probability .072. This result is fairly strong evidence that the tax increase reduced the cirrhosis mortality rate, at least in the short run.

Why did some (38 percent) of the states with increased taxes experience a relative increase in cirrhosis mortality? My interpretation is that cirrhosis mortality fluctuates from year to year for a variety of reasons besides changes in liquor prices. In some of the test cases, these chance fluctuations happened to be positive and large enough to more than compensate for the consumption-suppressing effect of the tax increase. The fact that in most cases (63 percent) the state exhibited a relative reduction in cirrhosis mortality suggests that this effect does exist.

The principal challenge to the validity of this interpretation is that a state legislature's decision to raise the tax is influenced, directly or indirectly, by cirrhosis trends in the state. For example, if a sudden increase in cirrhosis mortality led to a tax increase and a natural regression to the cirrhosis mortality trend subsequently occurred, then the tax increase would be followed by a reduction in mortality but would not necessarily have caused it. This possibility is tested in Cook (1981) and Cook and Tauchen (1982). The evidence from these tests does not support this interpretation of my result—tax increases apparently *are* largely exogenous.

My quasi-experimental approach to studying the effect of liquor taxes on heavy drinkers has the virtues of simplicity and ease of interpreta-

TABLE 3-1 Effect of State Liquor Tax Increases on Cirrhosis Mortality Rates, 1960-1974

Rank Order	Number of Test Cases	Percentage of Test Cases
1–5	9	63.2
6–10	9	
11–15	6	
16–20	3	36.8
21–25	9	
26–30	2	

Note: For each year during the sample period, the 30 states are rank ordered with respect to percentage change in cirrhosis mortality rate. The state with the largest reduction is ranked first. States that raised their taxes were usually at the low end (with the greatest reductions) of this distribution in the year of the tax increase.

Source: Cook (1981:277).

tion. It does not generate a usable estimate of the magnitude of the effect in question, however. Primarily for this reason I undertook a second study (Cook and Tauchen, 1982), which applied an estimation technique (analysis of covariance estimated by generalized least squares regression) to annual data from the same 30 states for the period 1962-1977. Before undertaking this task, we refined the annual state-level cirrhosis mortality data; our variable was the age-adjusted mortality rate for state residents ages 30 and over. Our principal result can be stated this way: other things being equal, a $1 per proof gallon increase in a state's liquor tax will reduce the state's cirrhosis mortality rate by 1.9 percent in the short run. (The tax variable in the regression was adjusted for inflation, as measured by the consumer price index. The statement of our results given here is converted to October 1981 dollars.) The 95 percent confidence interval for this estimated reduction is 0.4-3.5 percent; thus our parameter estimate is statistically significant by the usual standards of social science. Our parameter estimate suggests further that the tax effect is far from trivial—according to this estimate, a doubling of the U.S. federal liquor tax would reduce the nation's cirrhosis mortality rate by a figure in the neighborhood of 20 percent.

Given the normally long lag between the onset of heavy drinking and death from cirrhosis, it may not be obvious how an increase in the liquor tax could cause an immediate reduction in cirrhosis mortality. The reason is that the cirrhotic process is interruptible—if at any time an alcoholic should stop drinking, his or her liver would cease to deteriorate. If the rate of consumption slows, then the deterioration process also slows. At any one time, there is a reservoir of people who are within one year of death from cirrhosis at their current rate of consumption. If some of them reduce their consumption in response to a tax increase, then not all of them will die in that year—i.e., the mortality rate will decline in the first year. What about the trend in mortality over the long run? The mortality rate will gradually decline after the initial drop, as the size of the reservoir gradually shrinks. The total effect of the tax increase will not be realized for many years, but clearly the ultimate reduction in mortality rates due to such an increase will exceed the initial reduction. Thus, our figures underestimate the full effect.

In conclusion, there is considerable statistical evidence that a liquor tax increase causes an immediate and substantial reduction in cirrhosis mortality. If cirrhosis mortality rates are a reliable indicator of the prevalence of alcoholism, then it can be inferred that alcoholics' drinking habits are quite sensitive to the price of liquor.

The Effect of Liquor Taxes on Auto Fatalities There is also some direct evidence that accident rates are responsive to changes in the liquor tax. I tested the effect of state liquor tax increases on the auto fatality rate in my 1981 paper, using the same sample and technique as those in the cirrhosis study. Between 1960 and 1974, most of the states (25 of 38) that increased their liquor tax subsequently experienced a below-average change in auto fatality rates relative to states that did not increase their tax.

Unfortunately there is no comparable evidence on the effect of beer prices on auto fatalities. Beer is particularly important because it is the beverage of choice for the demographic group posing the greatest risk on our highways—young people.

Conclusion Available evidence suggests that increases in alcoholic beverage taxes cause reductions in per capita consumption, consumption by chronic heavy drinkers, and the incidence of drunken driving. It seems safe to conclude that the sharp decline in alcohol prices during the last 15 years has exacerbated alcohol-related public health problems. Fortunately there appear to have been countervailing forces at work during this period, such as increased emphasis in the popular culture on health and fitness, that have prevented a large increase in drinking from occurring. Indeed, adult per capita consumption has changed very little since 1970. If alcohol prices had kept pace with inflation, the per capita consumption would probably have declined substantially during this period.

Equity Considerations in Alcoholic Beverage Taxation

Alcohol control policies, including taxation, have been criticized by some as excessively blunt instruments, reducing the enjoyment of the many for the sake of curtailing the alcohol-related problems suffered by the relatively few. In the imagery of Gusfield (1976:275), these policies fall "like sober rain from heaven upon the problem and problem-free drinkers alike." There are two comments to be made in response to this critique.

First, much of the social cost of excess drinking also falls on "the problem and problem-free drinkers alike," as well as the abstainers. Our government social insurance tax rates and private auto and health insurance premiums reflect, in part, the costly consequences of alcohol abuse. The drunk driver puts all of us at increased risk of an injury or death on the highway. Thus, it can be argued that an effective alcohol control measure will indirectly benefit the problem-free drinkers (as well as those who abstain) by reducing the collective costs generated by problem drinking.

Second, the direct costs of alcohol control measures such as taxation are more or less proportional to the amount of alcohol an individual consumes—the "sober rain" falls on all drinkers, but with much greater intensity on the chronic heavy drinkers than on others. In the United States it is estimated that the heaviest-drinking 10 percent of the adult population consumes about 57 percent of all beverage alcohol sold each year (Gerstein, 1981:193). To the extent that alcohol taxes are proportional to ethanol content, then, this top group of drinkers will also pay 57 percent of the taxes. Thus, the relatively small group of drinkers who have the highest incidence of alcohol-related problems also pays the bulk of the alcohol taxes.

To summarize, alcohol taxes, if effective in reducing the costly consequences of excess consumption, reduce the burden alcohol imposes on society at large. Furthermore, whether or not alcohol taxes are effective in reducing the costly consequences of excess consumption, they have the characteristic of exacting payment in proportion to consumption and hence (very roughly) in proportion to the social costs generated by their consumption. If we believe that the drinker should pay (at least in an actuarial sense) for the social costs related to his or her drinking, then the excise tax on alcohol is reasonably efficient.

A second equity issue concerns the burden imposed on poor households by alcohol taxes. Such taxes are of course not adjusted to the household's ability to pay (as is the income tax), and by a traditional measure alcohol taxes appear regressive. However, it is certainly possible that an increase in alcohol taxes will actually prove beneficial to the children of the heavy drinkers in poor families. For example, if a household's demand for alcoholic beverages is elastic (price elasticity greater than 1.0), an increase in price will cause a reduction in total expenditures on drinking, thereby leaving more money for other household expenditures. Surely poor households vary considerably with respect to price elasticity of demand. However, the available evidence suggests that the average household's demand for liquor is quite elastic; furthermore, poor households would tend to be more elastic than higher-income households. Therefore, for some fraction of poor households, an increase in alcohol tax rates would reduce expenditures on alcoholic beverages. And, it is quite possible that a tax-induced reduction in

TABLE 3-2 Revenue Effects of Changing Federal Alcohol Excise Taxes: Proportional Increases

	Current		"Doubling" Option		"Restore to 1951 Levels" Option[a]	
	Excise Tax Rate	Tax Collections[b] (billions)	Tax Collections Zero Elasticity (billions)	Tax Collections Unit Elasticity (billions)	Tax Collections Zero Elasticity (billions)	Tax Collections Unit Elasticity (billions)[c]
Liquor (86 proof fifth)	1.81	3.94	7.89	6.35	14.86	8.90
Beer (six-pack)[d]	.16	1.49	2.98	2.82	5.61	4.84
Wine (gallon, 12% alcohol)[e]	.17	.21	.41	.41	.78	.76
Increase in revenues		0	5.64	3.94	15.62	8.86

[a] The price level in March 1983 exceeded the 1951 price level by a factor of 3.77.

[b] From 1979.

[c] These calculations assume that the own price elasticity of demand is unity for all three beverage types, with zero cross-price elasticities. Assumed prices were $7.50 per fifth for liquor, $2.80 per six-pack, and $8 per gallon of wine.

[d] The federal excise tax on beer is $9 per 31-gallon barrel, implying a $0.16 tax per 72-oz. six-pack.

[e] Wine tax rates are higher for fortified and sparkling wines.

consumption by heavy-drinking household heads may benefit other family members insofar as reduced drinking yields improved health and higher earnings.

Federal Revenues and Tax Rates

Currently federal excise tax collections on alcoholic beverages are about $6 billion. Table 3-2 provides estimates of the revenue effects from increasing excise tax rates uniformly on all three beverage tax rates. For example, if Congress were to double alcohol excise taxes (as they did cigarette taxes in 1982), a reasonable estimate of the revenue increase is $4 billion in the first year. The assumption behind this estimate is that the demand function for each beverage type is characterized by a constant elasticity of 1. (Revenue estimates for beer and wine are not sensitive to changes in this assumption.) Under the same assumption, revenue would increase by about $9 billion if Congress were to return alcohol beverage tax rates to 1951 levels in real terms.

Instead of increasing all three excise tax rates proportionately, Congress might be well advised to standardize tax rates per ounce of ethanol across all beverage types. Under the current tax structure, liquor is taxed at $.164 per ounce of ethanol, whereas the tax on beer is equivalent to about $.057 per ounce, and table wine about $.011 per ounce. Raising beer and wine taxes to the level of the liquor tax would bring in more revenue than doubling all tax rates and would have the important advantage of giving official recognition to the principle that ethanol is the problem agent, regardless of the type of beverage in which it is contained.

Conclusion

The decline in the real value of the U.S. federal excise taxes on alcoholic beverages has benefited heavy drinkers in some ways but has had the effect of increasing the prevalence of alcoholism and its attendant costs. Raising the excise tax would be a rather well-targeted response to the social burden that heavy drinkers as a group impose on the rest of society. There are a number of alternatives for reducing the U.S. budget deficit. Few of them have the substantial beneficial side effects that would result from raising the alcohol excise tax rates.

TESTIMONY OF

F.A. MEISTER

PRESIDENT/CHIEF EXECUTIVE OFFICER

DISTILLED SPIRITS COUNCIL OF THE UNITED STATES

TESTIMONY

BEFORE

COMMITTEE ON FINANCE

UNITED STATES SENATE

BUDGET RESOLUTION HEARINGS

JULY 16 1987

Mr. Chairman and Members of the Committee:

I am F.A. Meister, President and Chief Executive Officer of the Distilled Spirits Council of the United States (DISCUS), a trade association made up of approximately 90 percent of the manufacturers and marketers of distilled spirits. I am here to join with the beer and wine industries in opposing any increase in the excise tax on beverage alcohol. The beverage alcohol industry pays $5.5 billion annually in federal excise taxes and an additional $7 billion annually in state and local taxes. These excise taxes are among the most regressive of all federal taxes imposed on any product. Any increase in federal beverage alcohol taxes will go a long way toward offsetting all the savings to low and middle income Americans contained in last year's tax reform bill.

Our industry is strongly opposed to any further increase in the tax on distilled spirits. The tax on our product was just recently raised--in October, 1985--by $2.00 a gallon. The tax went up 19%--from $10.50 to $12.50 per proof gallon.

It is unfair to single out a struggling industry for tax hikes every time Congress struggles with the deficit. The 1985 tax hike hit our industry hard. Prior to the tax hike (FY 1981-'84) our sales declined 1.8% annually. Since the October 1985 tax hike, the decline in apparent liquor consumption quickened. As a result, excise tax collections did not meet Joint Tax Committee expectations. In fact, they were $670 million less than the Treasury and the JTC estimated for fiscal 1986. This is because (1) government assumed we were growing at 1.1% annually when in fact we were declining by 1.8% annually, and (2) government significantly underestimated the decline in consumption that would follow the 19% FET increase.

The situation was summarized recently by Stephen E. Higgins, Director of the Bureau of Alcohol, Tobacco and Firearms. He noted that after the 19% FET increase, shipment of spirits dropped 13% and that FET revenues rose only 3%.

While Fiscal Year 1987 may see a relative increase in federal spirits revenues, the impact of the tax hike on our industry was devastating. In calendar year 1986, spirits sales fell 5.8%, a decline in producer value of $300 million (exclusive of the FET). Spirits imports into the U.S. were down even more, 10.5%. Domestic capacity utilization declined 4 percentage points below 1985 levels. Industry-wide employment fell 5.4%, and manufacturing employment, that is our industry's blue collar jobs, dropped 6.6%.

As these dramatic decreases illustrate, we simply cannot stand another tax increase. In today's language, people refer to excise taxes as "sin" taxes, "externality cost" taxes, "abuse" taxes, and so on and so on. The simple fact of the matter is that whatever the word, excise taxes on liquor already are excessive and regressive.

A seductive but fallacious argument proposed by anti-alcohol groups is that increasing liquor taxes will decrease alcohol abuse problems. While excessive liquor taxes already are having a substantial negative impact on sales, it is not true that alcohol abuse problems will be reduced by even higher taxes:

1. Research clearly shows that alcohol abusers are those least likely to reduce alcohol consumption.

   The National Highway Traffic Safety Administration has stated that the majority of the alcohol related fatal crashes are caused by heavy problem drinkers who have on average had about fifteen drinks before driving. These are not the people whose drinking will be deterred by the price of alcohol.

   In their comprehensive 1983 review, "Alcohol Problems and Alcohol Control in Europe", Dermot Walsh, Director of Mental Health, Medical Social Research Board, Dublin, and Phil Davies, Research Scientist for the University of Aberdeen, Scotland, reviewed the experience of all European countries in this connection. They found that Sweden, which has imposed burdensome taxes and sharply increased prices on alcohol, has experienced growing rates of admissions to alcoholism treatment and drunk driving convictions. Proponents of the misuse of taxes for social policy reasons would have us believe that such measures would decrease alcohol abuse problems, but this has clearly not been the case.

2. Numerous experts on tax policy have stated repeatedly that the tax code is not the vehicle by which public morality should be dictated. The tax code should be based on revenue policy considerations, not social engineering goals.

3. High excise taxes on liquor unfairly penalize the vast majority of drinkers who are moderate and responsible and who do not in any way abuse alcohol.

4. Excessive excise taxes clearly are penalizing the liquor industry to the point that tax policy will drive our industry substantially out of business while promoting illegal production.

   In 1985, a two-day conference on "Alcohol Use in Latin America," sponsored by Brown University's Center for Latin American Research Director, Human Relations Research, located in Providence, RI. In this report, the author, Anna Cooper Heath, presented findings that controls over the production of alcohol beverages in Latin America has met with little success and indeed has often let to "moonshining" as a " . . . major cottage industry in many parts of Latin America." The report also states that "indexed pricing and heavier taxation . . . seems unlikely to affect those who habitually drink the most."

There is a limit to how much tax our industry and its consumers can bear. Recent experiences in other countries have demonstrated that punitive levels of spirits taxation can adversely affect public revenues which depend on steady or climbing consumption. In Australia, Canada, Denmark, Germany, Ireland, Japan, the Netherlands, and The United Kingdom projected revenue gains from spirits tax hikes were far off the mark. In fact, revenues actually declined in Denmark following a 37.5% tax increase. In Ireland, the government saw revenues fall by some 20% following a series of tax hikes. As a result, Ireland reduced its spirits tax by 20% as of October, 1984. In the United States, we are at that point of diminishing returns.

I hardly need to belabor the point that excise taxes are regressive. They are--hitting hardest at low and middle income people. They place a larger burden on those least able to pay. A recently released Peat Marwick study shows that the beneficial effects of the Tax Reform Bill for low and middle income people would be more than offset by excise tax increases on gasoline, tobacco, beer, wine and spirits. In fact the net effect would be to increase taxes on low income families by well over a billion dollars. It makes no economic sense to cut progressive taxes in one year and then substantially raise regressive taxes the next year.

Our industy's suffering translates into plant closings, job layoffs, and major job losses at the retail level where, of the 282,000 licensees who sell distilled spirits--two-thirds are mom-and-pop operations with four or fewer employees. Between 1978 and 1984, 28% of the liquor manufacturing jobs were lost. 1985 and 1986 saw a further 12% job loss.

Excise taxes are a traditional revenue source of the states. To the extent that federal excises are raised, states are deterred from tapping that source. Thus, in the past, the National Governors' Association has opposed federal excise tax hikes and President Reagan's original New Federalism proposal would have eliminated federal excise taxes entirely. Likewise, the National Conference of State Legislatures is on record as opposed to increases in federal excise taxes. States have been extremely active in raising excise taxes. State and local revenues from beer, wine and spirits are up by over 700% since 1951. From 1980 through 1987 there were 70 state tax increases on spirits. As a result of sales drops occasioned by the FET increase, we estimate state revenue collections may be off by $100 million.

The Revenue-Options pamphlet includes a provision which would index federal excise taxes. Such a provision would place costly administrative burdens on small retail and wholesale dealers in spirits. The Canadian experience with indexing taxes is instructive. Between April 1981 and September 1984, the Federal alcohol excise tax in Canada was automatically indexed to changes in inflation. The indexing policy had the following effects:

1. Federal spirits taxes were raised five times for a total of 53.7%.
2. Retail spirits prices increased almost 50%.
3. Spirits sales fell 15%.
4. 3,200 jobs were lost.
5. Revenue gains from the first three tax rate increases were totally offset by tax collection losses related to reduced consumption, by losses in personal and corporate income taxes and by welfare transfers.

Because of the unequivocal failure of the policy, the system of indexing was terminated in May 1985!

It makes no financial sense for the federal government to approve a proposal which, in the final analysis could result in less, not more revenues to the federal government. What is the logic and fairness of imposing an indexing proposal on just a few industries? It defies logic to index an already regressive consumer tax.

Yet another proposal would tax wine, and alcohol derived from flavors, at the distilled spirits rate when the wine, for example, is mixed with a distilled spirit to produce certain products. The wine does not become distilled; it remains wine. It is my belief that at whatever rate the Congress taxes wine or flavors it should not discriminate and necessarily raise that rate just because the wine or flavor is mixed with distilled spirits. The tax on wine or the alcohol in a flavor should be the same no matter who uses it, a bakery, a homemaker, or a distiller. The inequity of this proposal will adversely affect not only the distilled spirits industry, but also the wine and flavor industries.

That Congress always has taken this view is demonstrated by the fact that when what is now section 5010 of the Internal Revenue Code was accidentally repealed in the unamendable Trade Act of 1979, the section was retroactively reenacted in 1980.

The Revenue pamphlet also contains an option to eliminate the deductibility of alcohol advertising expenses. Such a provision would be a radical departure from the well-established rule of tax policy that ordinary and necessary business expenses can be deducted. Advertising is recognized as an important means to provide consumers with the information they need to make informed purchasing choices. Elimination of deductibility on alcohol could reduce consumer information. As the pamphlet points out in its arguments against this provision, "It is inappropriate to use discriminatory tax provisions to deal with non-tax issues involving alcohol and tobacco." The Distilled Spirits Council strongly opposes this limitation on advertising expenses for alcohol as well as the across-the-board limitation on advertising expense deductibility.

In summary, the liquor industry is traditionally seen as an easy political hit--a bottomless pit of money. That is not the case. We are a major and a legitimate industy--providing jobs and, indeed, 7 billion dollars of revenue annually to the federal, state and local treasuries. Like all industries, we feel the ebb and flow of economic tides. And for a number of years we have felt only the ebb. Consumer sales are the lowest per capita in twenty years. We are at a low point.

We do not ask for special treatment. We already pay more than our fair share. And just a year and a half ago you increased that share. There is a limit to our ability to pay. We believe that limit has already been reached in the spirits industry. That limit has already been passed.

Thank you for your consideration.

LCLAA

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La Voz del Trabajador, por Su Familia y Su País.

Statement of Jack Otero, National President
Labor Council for Latin American Advancement
Before the Senate Finance Committee
Hearing on Revenue Increase Options
July 15, 1987

My name is Jack Otero and I am testifying on behalf of the Labor Council for Latin American Advancement (LCLAA) of which I am the National President. LCLAA is one of five AFL-CIO support groups and speaks for more than one million Hispanic workers affiliated to AFL-CIO international unions.

Among the options to raise the $19.3 billion that is needed in additional revenues to meet Fiscal Year 1988 Budget targets is an increase in the federal excise tax on products such as gasoline, beer, alcohol or cigarettes. It is our contention that an increase in these taxes puts an unfair burden on working people in this country, most particularly, Hispanics and Blacks.

At a recent meeting of the LCLAA National Executive Board, a unanimous resolution was adopted opposing any increase in excise taxes. The regressivity of excise taxes has long been an accepted fact. The major excise tax increase analyzed in a January 1987 Congressional Budget Office study would wind up costing wealthy Americans 1/10th of 1 percent of their income, while the working poor would pay an astounding 27 times as much.

The same CBO study shows that a $19 billion increase in excise taxes would eliminate the entire income tax reduction under last year's tax bill for families with annual incomes under $30,000. Even worse, it would cost the working poor, including millions of Hispanics, more than double the savings they received under the Tax Reform bill.

LCLAA is fully supportive of the AFL-CIO's position that any necessary taxation should be progressive and based on the ability to pay. Like the AFL-CIO, we took a strong stand in support of last year's tax reform effort and we oppose any efforts to undermine the benefits that middle and low income families gained from this legislation.

JACK OTERO, BRAC
President

RALPH JIMENEZ, UAW
Executive Vice-President

OSCAR SANCHEZ, USWA
Secretary-Treasurer

Alfredo Montoya, USWA
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Damaso Seda, TWU • Linda Chavez Thompson, AFSCME

PAST PRESIDENTS
Ray Mendoza, LIUNA • Henry L. (Hank) Lacayo, UAW

"LATINO POWER THROUGH THE UNION CARD AND THE BALLOT BOX"

The 1986 Tax Reform Bill removed most of the working poor from the tax rolls and required American corporations to pay their fair share of taxes. However, we think that rates were cut too low for wealthy individuals and highly profitable corporations. We recommend that to maintain the concept of progressive taxation, the Committee should consider deferring or repealing the tax cuts which are scheduled to go into effect on January 1,1988, rather than raising taxes on low and middle income families.

We ask you to freeze the top individual tax rate at 38.5 percent, rather than reduce it to 28 percent. The 38.5 percent rate would apply to taxable income above $225,000 and would raise $4.7 billion in 1988 revenue.

The current phase-out rate of 33 percent applying to taxable incomes of more than $71,900 should be made an explicit rate of 33 percent. This would apply to taxable incomes between $71,900 and $225,000 and would raise $2.8 billion in 1988 revenue.

Both of these proposals would affect those most able to pay and would leave intact the intent of the 1986 Tax Reform Act for low and middle income families.

We also suggest that the top corporate rate be cut to 38.5 percent, rather than to 34 percent as proposed. This would yield $4 billion in 1988.

Other recommendations for raising revenue which LCLAA would support include freezing of the estate and gift tax rates at the 1987 level, the imposition of a luxury tax and a surtax on upper income individuals and corporations.

Along with losing the benefits gained from the tax reform act, Hispanic workers and their families face an even greater degree of unemployment and additional economic burden if Congress agrees to increase excise taxes. They are also facing the prospect of reduced sales and loss of jobs, particularly in the industries on whose products excise taxes are levied--alcohol, brewery, tobacco, gasoline and diesel fuel.

I hope that this Committee as well as Congress as a whole will join in my opposition to the financing of government on the backs of those who are least able to pay through regressive excise taxes and instead adopt alternatives based on the concept of progressive taxation which require the wealthiest individuals and corporations to pay their fair share.

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